DEC 1 2 1987

REPORT BY THE

Comptroller General

OF THE UNITED STATES

COMPLETED

The Federal National Mortgage Association In A Changing Economic Environment

FNMA is the nation's largest investor in residential mortgages. Its $88 billion in mortgages makes it the nation's third largest company. Its principal business--purchasing mortgages by raising funds with shorter-term debt--is inherently risky and can result in losses if interest rates rise or in greater profits if rates fall. Although not legally bound to provide assistance, the government may carry a contingent liability, because the financial community believes it would stand behind FNMA's debt if necessary.

Congress gave HUD oversight and regulatory authority over FNMA and wide discretion in performing this role. But HUD has not performed certain important functions, such as reporting to Congress on how FNMA's public benefits may be changing or how FNMA's growth has increased the government's potential risk.

GAO recommends that Congress clarify and strengthen the regulatory and oversight structure for FNMA and provide GAO with audit authority.

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

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The Honorable Jake Garn, Chairman, and
The Honorable William Proxmire,
Ranking Minority Member
Committee on Banking, Housing,
and Urban Affairs
Unites States Senate

The Honorable Donald W. Riegle, Jr.
United States Senate

The Honorable Henry B. Gonzalez
House of Representatives

The Honorable Stewart McKinney
House of Representatives

As requested in the Committee's letters of May 24, 1984, and June 14, 1984, and Senator Riegle and Congressmen Gonzalez and McKinney's joint letter of June 29, 1984, this report discusses

--how the secondary market for residential mortgages is changing and the Federal National Mortgage Association's (FNMA) role in that market;

--the interest rate and credit risks that FNMA incurs and its strategies for dealing with these risks;

--the privileges and constraints that affect FNMA in its public-purpose role and its profitability as a shareholder-owned corporation;

--the economic and social benefits that result from FNMA activities; and

--how the Department of Housing and Urban Development and the Department of the Treasury, as federal regulators, oversee FNMA activities.

We found that FNMA's operations expose the federal government and the credit markets to financial risk and that its activities have been supported to achieve public policy objectives. Given the public policy implications of FNMA's operations, we believe the corporation's activities should be continually monitored and periodically evaluated and audited.

We believe the recommendations to the Congress in this report will improve the regulatory, oversight, and evaluation functions relative to FNMA.

We are also sending copies of this report today to the appropriate House and Senate committees; the Secretary of Housing and Urban Development; FNMA's Chairman of the Board; the Director, Office of Management and Budget; and other interested parties.

Charles A. Bowsher

Comptroller General
of the United States

REPORT BY THE COMPTROLLER GENERAL OF THE UNITED STATES

THE FEDERAL NATIONAL MORTGAGE ASSOCIATION IN A CHANGING ECONOMIC ENVIRONMENT

D I G E S T

The Federal National Mortgage Association (FNMA or "Fannie Mae") is a federally chartered, private, for-profit corporation that was established to provide funds for residential mortgages. It is subject to oversight and regulation by the Department of Housing and Urban Development (HUD), and its borrowing must be approved by the Treasury. FNMA buys mortgages from mortgage bankers, savings and loan associations, and other lenders and acquires funds for its purchases by issuing various forms of debt securities and stock. It also issues and guarantees securities backed directly by mortgages and collects fees for this service.

FNMA owns an $88 billion portfolio of mortgage loans, many of which carry interest rates well below those it is required to pay in order to borrow in today's market. Much of its debt must be refinanced each year (estimated at $31 billion in 1985), while most of the mortgages in its portfolio are longer term and will not pay off for many years. The mismatch between interest rates on its assets and liabilities has resulted in substantial interest losses over the last 5 years. Throughout the 1970's FNMA was a profitable enterprise; but when interest rates increased rapidly to historic highs in the 1980's, the company began sustaining losses in 1981 and 1982. FNMA employed a strategy of buying new mortgages with higher interest rates and generating income from other sources to offset losses on its existing portfolio. This strategy has resulted in its portfolio growing from $57 billion in 1980 to $88 billion at the end of 1984. Although it has taken other steps to reduce both its interest rate risk and the likelihood of a future financial crisis, FNMA's portfolio growth increases the potential losses it would suffer should interest rates increase substantially (as well as profits if they fall).

If FNMA were a strictly private firm with no federal government connections and with a less prominent place in the financial markets, its activities would be of much less public interest. But the corporation was chartered to serve public policy objectives and enjoys significant

financial advantages from its government ties, most importantly lower borrowing costs. And there is a widely held perception in the credit markets that the federal government, although not required to do so by law, would step in with whatever aid was needed if FNMA experienced financial problems. The rationale is that the federal government would wish to avoid any negative impact on the housing industry or on the savings and loans, commercial banks, and other institutions that hold FNMA securities.

It is in this context that a variety of questions regarding FNMA and its operations take on public policy significance.

The Chairman and Ranking Minority Member of the Senate Committee on Banking, Housing, and Urban Affairs and subsequently Senator Donald W. Riegle, Jr., and Congressmen Henry B. Gonzalez and Stewart McKinney requested that GAO report on

--how the secondary market for residential mortgages is changing and FNMA's role in that market;

--the privileges and constraints that affect FNMA in its public-purpose role and its profitability as a shareholder-owned corporation;

--the interest rate and credit risks that FNMA incurs and its strategies for dealing with these risks;

--the economic and social benefits that result from FNMA activities; and

--how HUD and the Department of the Treasury, as federal regulators, oversee FNMA activities.

GAO does not have a statutory right of access to FNMA records. While FNMA provided much of the information GAO requested, it would not provide certain detailed records, such as the composition of its portfolio or its foreclosed loans, citing possible harm to its competitive position. In such instances, GAO relied on publicly available FNMA data. (See pp. 6-9.)

CHANGES IN THE MORTGAGE LENDING INDUSTRY

High, volatile interest rates in the late 1970's and early 1980's created a financial crisis for the savings and loan (thrift) industry and FNMA. Thrifts' financial positions deteriorated as depositors found better investments elsewhere and withdrew their deposits. As borrowing costs exceeded low-interest portfolio yields and higher yields on new mortgages depressed the value of older portfolio holdings, the industry's net worth plummeted; and a wave of mergers followed. Similarly, FNMA was caught in a position in which its borrowing costs exceeded the yields on mortgages it held in its portfolio.

By 1983, thrifts had acquired legislative and regulatory relief on three fronts. First, deregulation of deposit interest rates provided them access to funds, albeit at higher interest rates. Second, authorization to issue a variety of mortgage instruments (mainly adjustable rate mortgages) and additional non-housing loans provided them with access to assets that would more nearly match deposits with respect to yield and maturity. And finally, through FNMA and the Federal Home Loan Mortgage Corporation, the thrifts exchanged a large volume of low yield, illiquid mortgages for liquid, mortgage-backed securities. Using newly approved transactions known as "swaps" allowed them to avoid reporting accounting losses while enhancing their reserves. As the thrifts added large volumes of adjustable rate mortgages to their portfolios, their earnings became less vulnerable to increases in interest rates.

FNMA's heavy purchases of mortgages in recent years were fueled by considerations much like those of the thrifts; however, FNMA was not granted permission to acquire non-housing related assets. According to FNMA, its purchases are aimed at increasing income and creating a better match, with respect to yield and maturity, between their portfolio assets and their liabilities (debentures and notes). Toward that end, FNMA also began purchasing adjustable rate mortgages, which comprised 37 percent of loan purchases in 1984. The spread between the interest rates on its assets and liabilities has decreased from a negative 1.5 percentage points in 1981

to a negative 0.7 percentage points in 1984. (See pp. 10-19 and 20.)

PROFITABILITY AND INTEREST RATE RISK

After 12 profitable years, FNMA reported overall losses in 1981 and 1982 and again in 1984. The primary determinant of FNMA's profits and losses was its interest margin--the difference between the interest FNMA earns on its mortgages and other assets and the interest FNMA pays on the money it borrows. However, in the 1981-84 period, such factors as fee income, gains on the sale of mortgages, provisions for foreclosure losses, and administrative expenses were also significant determinants of FNMA's total profits or losses.

Two initiatives FNMA undertook in 1981 have been successful in producing earnings to partially offset the negative interest margins experienced in 1981-1984. These were (1) increasing fee income and (2) earning money from the positive interest margin on the large volume of mortgages purchased in 1981 and later years. These measures have also greatly increased the size of its portfolio. (See pp. 20-25.)

On one hand, these steps together with FNMA's efforts to reduce the maturity of its assets and lengthen the maturity of its debt, could be viewed as reducing the likelihood of a situation in which the implicit federal backing of FNMA's debt became an issue. But the sizeable increase in FNMA's portfolio also has increased the magnitude of the financial assistance the financial community expects the federal government would provide FNMA should it encounter serious financial difficulty. Such difficulty would occur if interest rates rise and remain at higher levels for an extended period, causing losses for FNMA because of the increased negative interest margin. Like many thrift institutions, this "interest rate" risk is the most serious problem that FNMA faces in the future.

Because GAO did not have access to the necessary portfolio data, it could not fully evaluate FNMA's risk reduction efforts or determine whether alternative strategies might have resulted in less risk without reducing profitability.

CREDIT RISK HAS PROBABLY INCREASED

In the process of increasing earnings, FNMA may also have increased credit risk. FNMA's foreclosure losses for 1984 were $97.3 million. Total foreclosure volume was actually much greater, but mortgage insurers reimbursed FNMA for nearly $600 million in 1984. These foreclosure losses were up from $38.4 million in 1983 and $1.6 million in 1982.

FNMA probably increased its exposure to foreclosure when it added a large volume of loans to its portfolio in 1981 through 1984. This was due to a combination of factors including:

--changes in FNMA business practices, such as relying on lenders to ensure that loans sold to FNMA met its underwriting standards;

--property value stagnation; and

--writing loans with payments that increase rapidly during the first few years after origination, regardless of the movement in interest rates.

As a result of its losses, FNMA has taken steps to reduce its potential foreclosure losses in the future, such as stressing the need for lenders to conform to underwriting standards, but the success of these moves cannot be predicted. (See pp. 38-49.)

Improved economic conditions and the resumption of modest property appreciation could be expected to moderate FNMA foreclosure losses in the future since it is largely insured against credit risk by private mortgage insurers.

FNMA BENEFITS TO HOUSING AND MORTGAGE FINANCE AND FEDERAL SUPPORTS

Although individuals, investors, and institutions have always purchased mortgages for investment portfolios, the growth of a national secondary mortgage market really began with FNMA's restructuring in 1968. In cooperation with the Federal Housing Administration (FHA) that insured mortgages providing additional security to investors, FNMA developed standard mortgage instruments and practices and helped create a national market in residential loans. To perform this market building role FNMA was

Tear Sheet

provided with a variety of financial supports, but its business was limited to the residential secondary mortgage market exclusively.

Financial advantages

FNMA receives a variety of financial supports including the following: Treasury authority to purchase FNMA securities under terms that Treasury would prescribe should this ever be necessary; exemption from state and local income taxes and Securities and Exchange Commission (SEC) registration fees; and the ability of regulated financial institutions, such as banks and pension funds, to hold FNMA debt in the same way as Treasury debt. In turn, FNMA's secondary market activity is limited to mortgages below limits established by Congress, currently set at $115,300.

These advantages have saved FNMA millions of dollars in fees and taxes; but, more importantly, they create the impression that FNMA is an agency of the federal government. This perception allows FNMA to receive the highest private quality rating possible for its debt and to borrow at interest rates that are usually close to those of the U.S. Treasury. Without this advantage, FNMA could be expected to pay substantially higher debt costs and according to FNMA would be unable to operate in the secondary market at anything approaching its present level. In 1983, FNMA's most recent profitable year, a one-half percentage point increase in its average borrowing costs would have cost FNMA an additional $157 million, which would have more than offset its profits for that year.

As FNMA's mortgage portfolio has grown, the aggregate value of these financial advantages has increased. Recent changes in the tax treatment of its losses and modest relaxation of HUD regulatory restrictions on its assets (for example, it can now buy second mortgages) have also added to its profit potential. (See pp. 77-88.)

FNMA benefits to society

FNMA's charter defined its role as providing ". . . supplemental assistance to the secondary market to home mortgages by providing a degree of liquidity for mortgage investments, thereby improving the distribution of investment capital

available for home mortgage financing." The purpose was to help establish a secondary market for mortgages. This supplementary assistance function has been interpreted by FNMA and others to encompass a variety of activities. Such activities include redistributing credit geographically, tapping non-traditional sources of funds, and providing mortgage funds when other lenders withdraw from the market during credit crunches. The Charter Act and HUD regulations also require that a reasonable portion of FNMA mortgage purchases assist low- and moderate-income households but with reasonable economic return to the corporation.

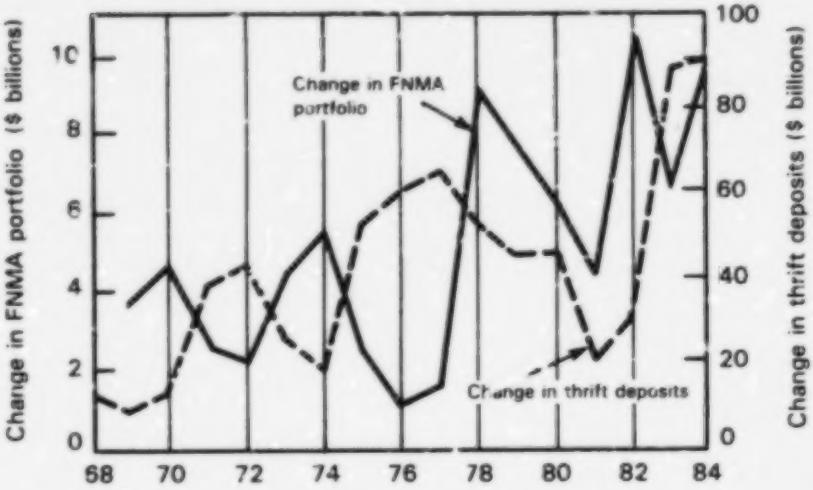
FNMA performed its supplemental assistance and market-building function by serving as a national supplier of mortgage funds, providing an outlet for loans from federal mortgage programs and housing subsidy programs, and increasing its purchases of mortgages during periods of scarce credit. But conditions changed: the primary and secondary mortgage market grew, the thrift industry was deregulated, and other federal credit agencies such as the Government National Mortgage Association (GNMA) became active in the secondary mortgage market. With these changes, certain of the significant benefits that FNMA provided in the 1970's appear to have declined while FNMA has responded to new market demands.

For example, through the mid-1970's FNMA was the principal buyer of FHA/VA single-family and FHA multifamily project loans. A variety of factors have shifted FNMA's new business largely to conventional single-family loans for middle-income households. Government subsidy programs utilizing FHA rental housing loans were phased out, and, until recently, FNMA could not purchase conventional multifamily rental housing mortgages. In addition, GNMA began guaranteeing FHA/VA mortgage-backed securities in 1970, providing a lower-cost source of funds for these loans, while FNMA moved into the conventional mortgage market in 1972. As a result, conventional loans began to dominate FNMA purchases in 1976 and amounted to nearly 99 percent of its purchases in 1983. (See pp. 56-74.)

Furthermore, in earlier credit cycles, increases in interest rates and the resulting decrease in deposits at thrift institutions caused by limits on what they could pay depositors, created a natural countercyclical role for FNMA. It could

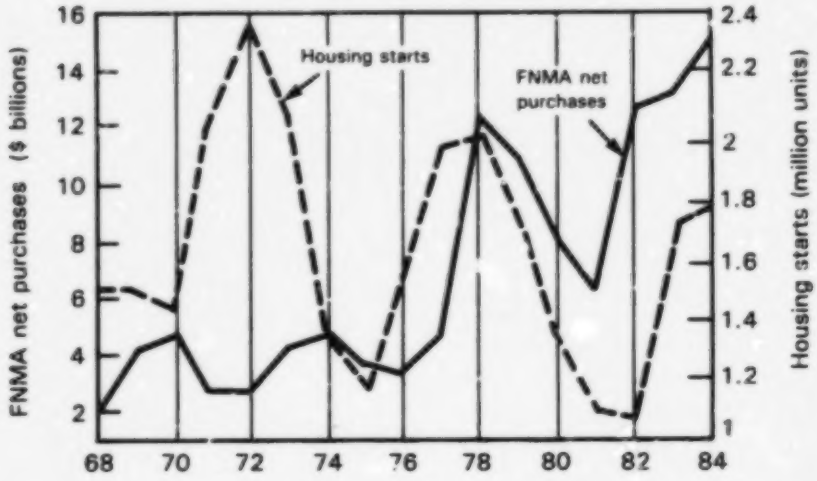
Figure 1
FNMA's Countercyclical Role

FNMA's portfolio activity tended to offset declines in thrift deposits in the early 1970's . . .



. . . but in the 1979-1984 period FNMA and thrift deposits generally moved in the same direction.

FNMA has typically increased its mortgage purchases as housing production falls . . .



. . . but FNMA purchases moved down with housing starts beginning in 1979 and rebounded in the 3rd quarter of 1981 just before starts picked up in the 2nd quarter of 1982.

Source: FNMA and Data Resources, Inc.

still borrow and, therefore, absorb mortgage-lending business lost by savings and loans and other depositories through its purchase of loans from mortgage lenders. Deregulation and the resulting closer integration of housing finance into the credit markets have probably reduced this FNMA role. In the last housing downturn, when thrifts were still limited to some extent by interest rate ceilings, FNMA's activity did not appear to be countercylical. (See figure 1.) Rather, its loan activity seemed to follow the trends in thrift deposits and did not increase as housing starts declined or decrease as mortgage lending in general rebounded. (See pp. 62-63.) FNMA contends that its role has changed from one of improving the supply of credit prior to 1980, to one of decreasing the cost of credit during downturns in housing. Based upon the information provided by FNMA, GAO was unable to verify this contention. FNMA also notes that it taps a broader investor base than other secondary market participants because it can issue short and intermediate term debt that is attractive to investors who would not invest in mortages or mortgage backed securities.

HUD HAS NOT FULLY EXERCISED ITS OVERSIGHT ROLE; TREASURY'S ROLE ROUTINE

In setting up FNMA as a private corporation, Congress recognized that safeguards, in terms of HUD and Treasury oversight, were needed to ensure that FNMA would carry out its public functions and use its borrowing powers in a responsible way. (See pp. 89-103.)

HUD oversight and regulation

Under FNMA's charter, HUD is empowered to issue rules and regulations to ensure that the act's purposes are accomplished, review FNMA's financial operations, and prepare studies on the extent to which FNMA meets the purposes of the act. Certain of these regulatory powers must be exercised consistent with maintaining a reasonable economic return to FNMA and its stockholders. Also, HUD regulation may not extend to "usual" corporate matters, such as setting salaries. For the most part, the act gave HUD considerable discretion in the extent to which it regulates and oversees FNMA. HUD has carried out some of its oversight activities, such as issuing regulations and reviewing FNMA requests

to undertake new programs. Within the limits of its review, GAO identified several areas in which HUD's oversight performance has fallen short of what GAO believes Congress envisioned in the charter:

--The Charter Act called for HUD oversight of FNMA operations. While HUD established a FNMA oversight unit within its Office of General Counsel shortly after issuing its 1978 revised regulations, the unit was disbanded in 1981. Presently HUD has no staff dedicated exclusively to FNMA oversight.

--Although HUD has audit authority and access to FNMA records, it has chosen not to utilize its audit authority in favor of FNMA's independent financial auditors. This may be consistent with the private, but not necessarily the public-purpose, side of FNMA's identity. HUD has not directly accessed FNMA's files and records and, therefore, data on certain aspects of FNMA operations, having public policy implications, are not available to the government or the Congress.

--HUD has not analyzed the financial risk to which FNMA exposes the government or evaluated alternative risk management strategies which FNMA might pursue.

--More generally HUD has not undertaken a study of how well FNMA still serves its public purpose role. For example, it has not recently attempted to determine whether a reasonable portion of FNMA's purchases benefit low- and moderate-income households and no longer requires FNMA to submit the information necessary to do so.

--HUD has not submitted a report on FNMA activities required by Congress since 1978. Recent legislation dropped this requirement in favor of an annual report but HUD says it is now preparing the originally required report voluntarily.

HUD officials responsible for oversight and regulation are unsure of the nature of their role. They believe the public-sector regulation of a private-sector corporation as laid out in the charter was inconsistent. HUD officials told GAO they have no clear sense of what regulations are needed to ensure that charter pur-

poses are achieved, the specific FNMA activities HUD should regulate, or whether HUD should or could develop the capability and expertise to be a "watchdog" over FNMA's risk management activities. Finally, HUD officials do not believe the Department presently has the capacity or expertise to perform certain functions which might be expected of a financial institution regulator, such as monitoring FNMA's interest rate risk.

GAO believes that the relationship between FNMA and the government is quite different than that of other regulated industries. FNMA's ties to the government and its implicit "agency status" imply the government's oversight should extend to evaluating the reasonableness of the risk FNMA is taking and the degree to which it is achieving public purposes.

Treasury oversight

Treasury controls FNMA debt through approval of new issuances of FNMA's debt securities. The Treasury issues a regular calendar schedule that sets a specific time each month that FNMA can issue its longer-term debentures. In addition, FNMA can borrow "off-calendar" with Treasury approval as long as it does not interfere with Treasury or other "agency" borrowers. According to FNMA, HUD, and Treasury officials, a mutually agreeable calendar schedule has been established, and approvals of off-calendar borrowing are generally routine. A noteable exception was Treasury disapproval of FNMA's request to issue bearer debt in offshore markets. (See pp. 103-104.)

RECOMMENDATIONS TO THE CONGRESS

FNMA's multiple links to the federal government expose the government to a potentially large but ill-defined financial risk. This arrangement was created on the premise that FNMA's operations would achieve public policy objectives.

GAO could not fully explore every aspect of HUD's regulatory and oversight performance in the time available. GAO believes, however, that the Department's performance has fallen short of what Congress envisioned in the Charter Act. Furthermore, FNMA's significant growth, its losses in recent years, and the level of risk which it must now take to continue operating were probably not anticipated in 1968. As a

result, Congress may not always have had adequate information regarding FNMA's activities, and certain important regulatory and oversight functions may not have been performed, during a period when economic and legislative changes have buffeted the home lending business.

To improve the regulatory, oversight, and evaluation functions relative to FNMA, GAO recommends that Congress

--establish by legislation a permanent oversight function within HUD or some other federal regulatory entity that will monitor FNMA activities, evaluate how well it performs its public policy objectives, and periodically report to the Congress on these matters.

--clarify in legislation the regulatory role desired by Congress, particularly as regards aspects of FNMA's operations such as its portfolio operations which expose the federal government to financial risk.

In carrying out this review, GAO did not have legal access to all the information needed and had to rely on information provided voluntarily by FNMA. GAO therefore recommends that Congress provide it with the authority to audit FNMA's financial records and evaluate its programs and with the right to access all FNMA corporate records. This would allow GAO to be more responsive to the needs of Congress. (See pp. 109 and 117-118.)

AGENCY COMMENTS

FNMA comments

The corporation said that GAO had successfully identified the key issues relative to FNMA's operation. But FNMA suggested that GAO had downplayed certain of the benefits it provides while focusing on its earlier role in assisting low- and moderate-income households and providing countercyclical credit support. It states that its role has changed along with the mortgage market but it maintains that it still provides these earlier benefits as well as a wide variety of others.

FNMA said that GAO's recommendations, if improperly interpreted, could be used to argue for limiting the corporation's management flexibility. They acknowledged the need for FNMA

oversight but suggested that HUD regulation should be performance oriented with the corporation periodically reviewed against public policy objectives. FNMA also said that GAO audit authority was inconsistent with the corporation's private business identity. (See pp. 118 and 133.)

GAO response

GAO analyzed a whole range of potential FNMA benefits, but emphasized the low- and moderate-income and countercyclical benefits in particular because these have been thought of as key to the corporation's public purpose.

As regards regulation and oversight, GAO did not suggest any particular federal role and certainly not one that would limit the corporation's ability to manage. For example, one appropriate role might be analagous to that of regulators of other financial institutions. Thrift institutions are free to manage within broad parameters to produce a profit, yet the riskiness of their loan portfolios is monitored in terms of both credit and interest rate risk. If necessary, financial regulators can require a thrift institution to modify its business activity to mitigate risk.

GAO's recommendation on audit authority is consistent with its long standing position that, except for entities GAO is required to audit by law, government sponsored or chartered corporations should be audited by independent private accountants, but that GAO should be empowered to review these audits and should have authority to access records and perform audits and evaluations of these corporations. (See p. 118.)

HUD comments

HUD said that the GAO report would be useful to the Department in completing its report on FNMA, and made three major points:

--HUD has concentrated on program approvals and their public implications, and has structured its oversight role to avoid duplicating the efforts of others, such as FNMA's independent auditors and the Treasury. The Department noted that some overlaps, such as exist between the FHLBB's supervisory responsibilities over thrifts and those of the thrifts' internal auditors may be necessary.

--Given changes in the size and nature of FNMA's activities, it may be time to reconsider the government's regulation and oversight of FNMA as GAO suggests. In particular, Congress probably did not envision the risk to which FNMA now exposes the government, although monitoring this risk may be beyond HUD's capacity.

--Despite HUD objections, Congress recently weakened its regulatory control over FNMA by voting to remove HUD approval of its debt and certain mortgage purchase programs.

HUD concludes that GAO indirectly raises a more basic question of whether the present level of FNMA benefits to society justifies its unique advantages. HUD believes this question is central to congressional re-examination of FNMA. (See p. 107-108 and 118-119.)

GAO response

GAO agreed in general with HUD's comments, including the observation that GAO's work raises the basic question of whether Congress should reconsider FNMA's public purpose role. GAO believes the information in its report provides a base on which the Congress could build if it were to do so. With respect to HUD's role GAO noted that:

--HUD's evaluation efforts relative to FNMA's public purpose should not be confined to studying new FNMA programs, but should include a periodic look at all FNMA activities in terms of its contribution to public policy objectives.

--Although HUD concludes that it probably does not have the capacity to act as a financial regulator or "watchdog" in evaluating FNMA's risks, this is nonetheless an important function. If HUD does not have, or cannot develop, this capability it could contract with another financial regulatory agency to perform this function.

--Improved oversight, evaluation, and regulation as suggested by GAO would aid any Congressional re-examination of FNMA's role. (See pp. 108-109 and 119-120.)

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ABBREVIATIONS

ARM	Adjustable rate mortgage
CMO	Collateralized mortgage obligation
DIDMCA	Depository Institutions Deregulation and Monetary Control Act
DIDC	Depository Institutions Deregulatory Commission
FDIC	Federal Deposit Insurance Corporation
FFB	Federal Financing Bank
FHA	Federal Housing Administration
FHLBB	Federal Home Loan Bank Board
FHLMC	Federal Home Loan Mortgage Corporation ("Freddie Mac")
FmHA	Farmers Home Administration
FNMA	Federal National Mortgage Association ("Fannie Mae")
FSLIC	Federal Savings and Loan Insurance Corporation
GAO	General Accounting Office
GEM	Growing equity mortgage
GNMA	Government National Mortgage Association ("Ginnie Mae")
GPARM	Graduated payment adjustable rate mortgage
GPM	Graduated payment mortgage
HUD	Department of Housing and Urban Development
IRS	Internal Revenue Service
LTV	Loan-to-value
MBA	Mortgage Bankers Association
MBS	Mortgage-backed security
MI	Mortgage insurance
NOW	Negotiable order of withdrawal
OIG	Office of Inspector General
OMB	Office of Management and Budget
S&L	Savings and loan association
SEC	Securities and Exchange Commission
SLMA	Student Loan Marketing Association ("Sallie Mae")
SMSA	Standard metropolitan statistical area
SSC	Small saver certificate
VA	Veterans Administration

CHAPTER 1

INTRODUCTION

The Federal National Mortgage Association (FNMA or "Fannie Mae") is the largest holder of U.S. residential mortgages, with almost 6 percent of all U.S. home mortgage assets in its investment portfolio. As of December 1984 it held a net portfolio of $84.4 billion[1] in mortgages and had total assets of $88.4 billion, making it the third largest corporation in the United States (as measured by assets). In 1984 FNMA borrowed over $47.9 billion, making it the second largest borrower in the country. Only the federal government borrowed more.

FNMA is a federally chartered, private, for-profit corporation established to provide supplementary assistance to residential mortgage markets. FNMA does this by buying mortgages from savings and loan associations, mutual savings banks, mortgage bankers, and others that can use these funds to make additional mortgage loans. Purchases and sales of mortgages create a "secondary mortgage market." FNMA acquires funds for its purchases by issuing stock and debt securities, from income from mortgages in its portfolio, and from other sources.

Persistent inflation and soaring interest rates in the late 1970's and early 1980's caused FNMA's cost of borrowing to exceed the rate of return it could realize from its mortgage portfolio that was dominated by older and generally lower-yielding mortgages. FNMA reported net losses of $190.4 million and $104.9 million in 1981 and 1982, respectively, but, due to aggressive countermeasures and declining interest rates, turned a $75.5 million profit in 1983. However, in 1984 FNMA suffered a $57.4 million loss.

At the end of 1984, FNMA's borrowing costs still exceeded the yield on its loan portfolio--11.6 percent versus 10.9 percent, respectively. Also, FNMA's actions to restore its profitability, combined with an environment of continued high interest rates and low housing price inflation, resulted in increased losses from foreclosure: in 1984 FNMA had foreclosure losses of $87.3 million. This was an increase from its losses of $1.6 million in 1982 and $38.4 million in 1983.

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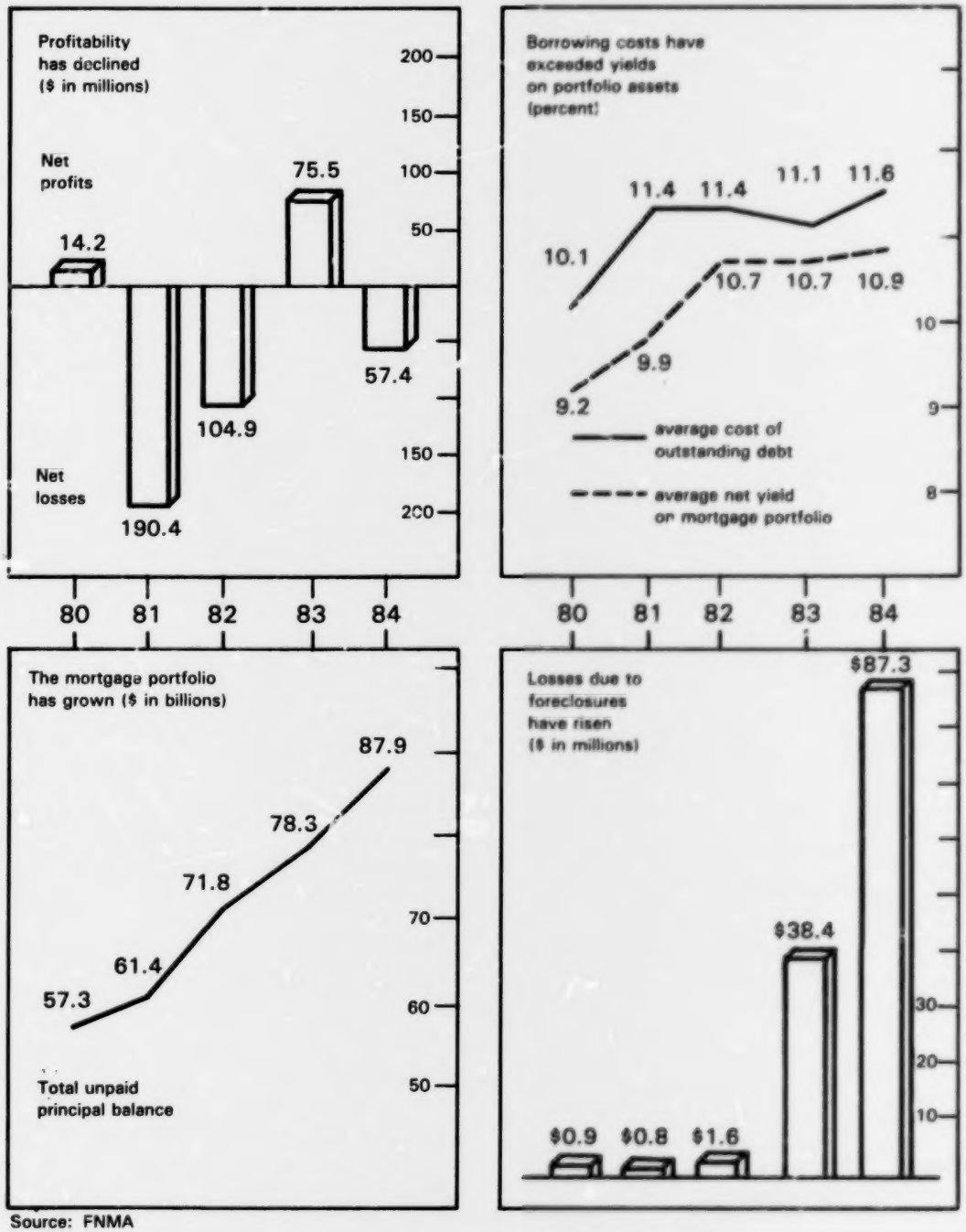
[1]The net portfolio figure is calculated by subtracting the unamortized discount ($3.4 billion) and the allowance for foreclosures ($0.1 billion) from the total unpaid principal balance for all mortgages ($87.9 billion) as shown on p. 21 of the 1984 FNMA annual report.

Figure 1.1
FNMA's Portfolio Size, Profitability, Borrowing Cost, and Foreclosure Experience: 1980-1984



Source: FNMA

Most important, however, is that FNMA's recent experience and its outlook for the future have raised questions regarding the financial risks it faces in the market place. Due to FNMA's special relationship with the federal government (as discussed below) and the potential effects of a FNMA financial crisis on the credit markets, the financial community expects that the federal government would step in and assist FNMA in a financial crisis. Although not required to assist FNMA by law, this potential can be thought of as a contingent liability for the federal government.

FNMA: A PRIVATE CORPORATION WITH A PUBLIC PURPOSE

FNMA was established in 1938 as a wholly owned government corporation to provide additional funds to the residential mortgage market and was transformed into a federally chartered, privately owned, for-profit corporation in 1968 by amendments to the Federal National Mortgage Association Charter Act (12 U.S.C. 1716 et seq.) (the "charter act"). FNMA acquires residential mortgages in fulfillment of its legislative charter ". . . to provide supplementary assistance to the secondary market for home mortgages by providing a degree of liquidity for mortgage investments, thereby improving the distribution of investment capital available for home mortgage financing." It does this by buying mortgages from savings and loan associations, mortgage bankers, and others who lend money directly to homebuyers.

FNMA is one of the major forces in the secondary mortgage market, defined here as the collection of institutions involved in trading mortgages and mortgage-related securities. It is the largest single mortgage investor in the country. At the end of 1984, FNMA held $88 billion in mortgages in its portfolio. Due to the volume and short-term nature of its debt, FNMA is also one of the nation's major borrowers, second only to the U.S. Treasury in yearly volume of borrowing.

While FNMA is a private, stockholder-owned corporation, it also has a variety of obligations, restrictions, and privileges that cause it to be viewed in the investment community much as an "agency" of the federal government. This usually allows it to borrow at rates just above those paid by the Treasury. It is headed by an 18-member board of directors, of whom the stockholders elect 13 and the President of the United States appoints 5. FNMA was created as an outgrowth of legislation restructuring home financing after the collapse of the housing industry in the 1930's

The current charter provides for the Department of Housing and Urban Development (HUD) and the Department of the Treasury (Treasury) to oversee and regulate certain FNMA activities. The Charter Act authorizes HUD to exercise general regulatory power and rulemaking authority over FNMA by

--approving new conventional mortgage programs that FNMA can carry out;

--approving issues of stock, securities, and other debt;[2] and

--auditing FNMA's books and, at its discretion, requiring reports on FNMA activities.

HUD may also require that a "reasonable" portion of FNMA's mortgage purchases be related to providing housing for low- and moderate-income families, but only to the extent that these purchases provide a "reasonable economic return" to FNMA.

The Treasury must approve the type, amount, rate, maturities, and timing of FNMA's debt issues. Also, the FNMA Charter Act authorizes the Secretary of the Treasury to purchase FNMA obligations up to a maximum of $2.25 billion outstanding at any time--though FNMA has never used this source of borrowing.

FNMA obligations are not guaranteed by the U.S. government. However, its debt issues are classified in credit markets as having federal "agency status," and the general consensus of the financial community has been that its size and position in the financial system are such that the federal government would come to its assistance in a financial crisis.

FNMA does not lend money directly to homebuyers. It is, however, an integral part of the interdependent system for financing housing in the United States today.

THE HOUSING FINANCE SYSTEM IN BRIEF

The typical homebuyer in the United States borrows money from a local lender (most often a savings and loan association or mortgage banker) and that lender receives a mortgage as security against the possibility of default. The borrower's down payment --and in many cases, mortgage insurance--provides additional security for lenders.

The lender may retain the mortgage as an asset or sell it in the secondary market. The secondary-market investor, of which FNMA is one, may purchase and retain the mortgage as a portfolio asset or, alternatively, pool it with similar mortgages as the backing for a security issue. These mortgage-backed securities may be held by the investor or sold in shares to other investors. The security generally carries a guarantee of payment of principal and interest that, combined with other characteristics of the

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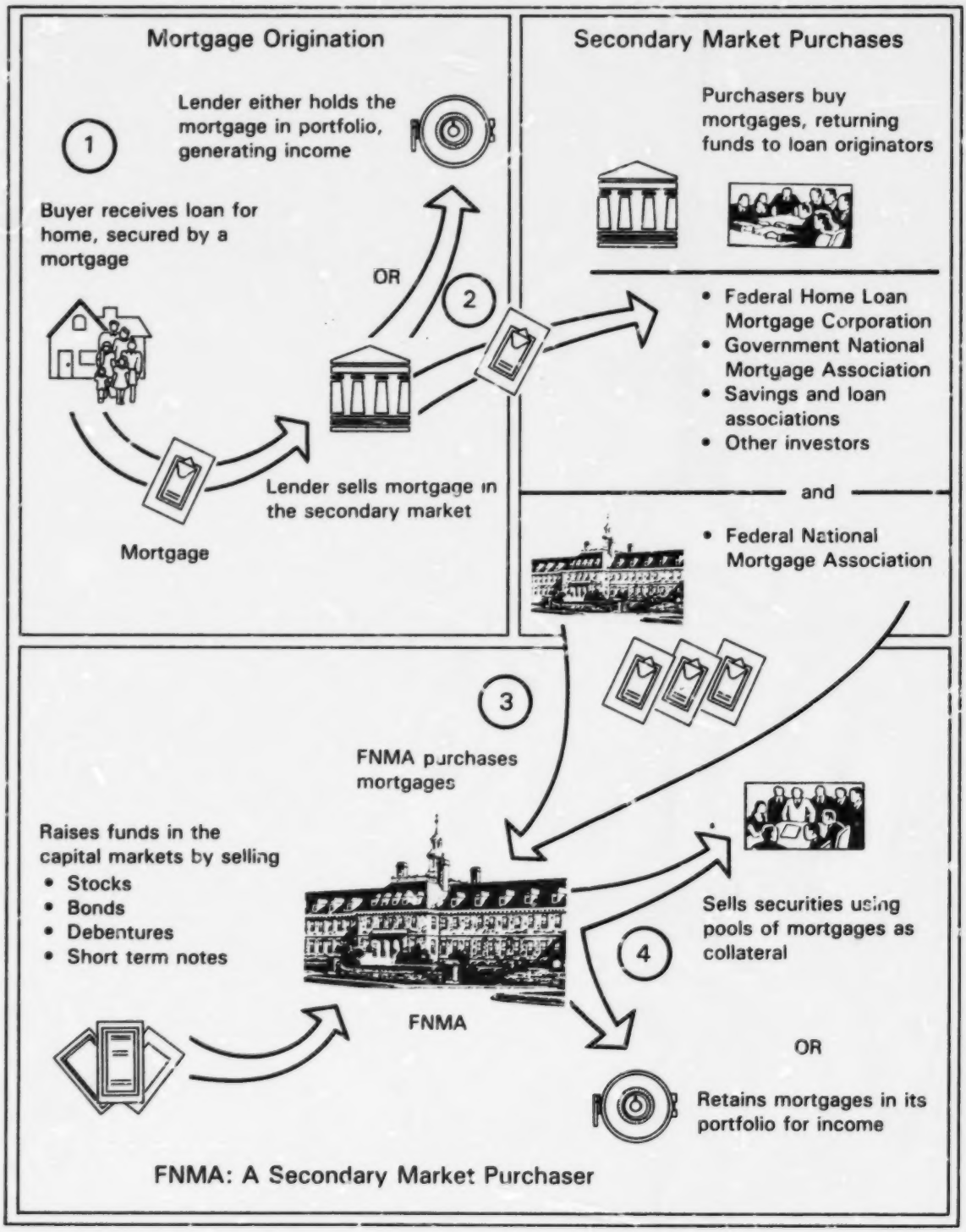
[2]The Secondary Mortgage Market Enhancement Act of 1984 removes this authority with respect to securities and debt (unless the debt is convertible to stock) effective October 1, 1985.

Figure 1.2
FNMA and the Housing Finance System



security, make it more liquid and hence more attractive to investors than individual mortgages.

OBJECTIVES, SCOPE, AND METHODOLOGY

We prepared this report in response to May 24 and June 14, 1984, requests by the Chairman and Ranking Minority Member of the Senate Committee on Banking, Housing, and Urban Affairs and a June 29, 1984, joint request from Senator Donald W. Riegle, Jr., and Congressmen Henry B. Gonzalez and Stewart McKinney (the requests are reprinted in appendix I). While the three requests covered many issues, the requesters' offices agreed that this review's objectives would focus on providing information on

- --how the secondary market for residential mortgages is changing and FNMA's role in that market (see ch. 2);
- --the interest rate and credit risks that FNMA incurs and its strategies for dealing with these risks (see ch. 3);
- --the privileges and constraints that affect FNMA in its public-purpose role and its profitability as a shareholder-owned corporation (see ch. 4 and 5);
- --the economic and social benefits that result from FNMA activities (see ch. 5); and
- --how HUD and Treasury, as federal regulators, oversee FNMA activities (see ch. 6).

The requesters' offices agreed that certain other topics in which they were interested--notably modeling scenarios on strategies to reduce the asset and liability mismatch and possible risks to the government of those strategies; assessing FNMA managerial and staff capacities; and comparing salary, compensation, overhead, and other costs to similar institutions--would not be addressed in this report.

To help us plan our work and provide perspective on FNMA's role in the secondary mortgage market, we sponsored a conference in July 1984 in Washington, D.C. This conference brought together financial experts from FNMA, the Federal Home Loan Mortgage Corporation (FHLMC), the Federal Home Loan Bank Board (FHLBB), HUD, and the Federal Reserve Board, as well as some of Wall Street's principal participants in the secondary mortgage market and academic experts. The panel explored mortgage markets generally and FNMA's participation in those markets specifically.

To meet the request objectives, we reviewed the FNMA Charter Act and recent legislation that directly or indirectly affects FNMA, such as 1980 banking deregulation legislation. We also reviewed the legislative histories of the legislation, hearings

and reports involving congressional oversight of FNMA and the financial community and pertinent regulations. We performed an extensive literature search using several information retrieval systems and other sources to provide background on FNMA and the financial and secondary mortgage markets and to provide support for analyses presented in this report.

We also met with a broad variety of officials and other experts from FNMA, HUD and Treasury, other governmental organizations, and the financial and housing communities. Our discussions included experts from the Office of Management and Budget, the Securities and Exchange Commission (SEC), Federal Reserve Board, FHLMC, FHLBB, Department of Labor, U.S. League of Savings Institutions, Mortgage Bankers Association of America, private mortgage insurance companies, and officials at various private financial institutions doing business with FNMA. These contacts provided the necessary background and perspective to approach the work and provided information related to specific topics covered in our review.

For financial data related to FNMA and the financial and housing market activity, we used, among other sources, the Department of Commerce's Business Conditions Digest; the Federal Reserve System's Flow of Funds Accounts, Quarterly Levels and Federal Reserve Bulletin; HUD's Survey of Mortgage Lending Activity and various internal HUD documents; the FHLBB's Savings and Home Loan Financing Book; and the Factbook and Directory of the Mortgage Insurance Companies of America. We also used a variety of public FNMA documents including annual reports to stockholders; FNMA data packets prepared for investors and analysts; and other publications FNMA prepared for us dealing with topics such as the benefits of FNMA, FNMA's history, and FNMA's role as a portfolio investor. We further obtained comparisons of FNMA borrowing costs to interest rates on Treasury and U.S. agency debt and to corporate debt issues of like maturities. The Treasury comparison was obtained from FNMA; the corporate comparison was based on data compiled by Salomon Brothers, Inc. We obtained and analyzed documents and agency analyses pertaining to HUD and Treasury oversight and correspondence among HUD, Treasury, and FNMA related to the oversight role.

To supplement our analyses we commissioned academic housing-finance experts to prepare papers that were presented at a second conference, a symposium held in February 1985, in Washington, D.C. For each paper, we also contracted with a discussant to critique the paper at the conference. Discussants were academicians selected for their expertise in the subject areas, a former HUD Associate General Counsel responsible for FNMA regulatory activities, and a consultant on housing policy and programs. The symposium moderator, Anthony Downs, is a senior fellow at the Brookings Institution, who has published widely on housing-related topics. Topics of the symposium papers were as follows:

--"FNMA and the Housing Cycle: Its Recent Contribution and Its Future Role in a Deregulated Environment," prepared by Herbert M. Kaufman, Professor of Economics, Arizona State University. George von Furstenberg, Rudy Professor of Economics, Indiana University, commented on the paper.

--"An Analysis of the Credit Risk Inherent in FNMA's Recent Portfolio Acquisitions of Adjustable Rate Mortgages," prepared by Kerry D. Vandell, Associate Professor of Real Estate and Regional Science, Southern Methodist University. Donald Cunningham, Assistant Professor of Finance and Real Estate, Baylor University, commented on Professor Vandell's paper.

--"An Interest Rate Risk Analysis of the Federal National Mortgage Association," prepared by James J. Clarke, Associate Professor of Finance, Villanova University. Edward Kane, Reese Professor of Banking and Monetary Economics, Ohio State University, discussed Professor Clarke's paper.

--"Fannie Mae and its Relationship to Low- and Moderate-Income Families," prepared by Richard B. Clemmer, Associate Professor of Economics, Central Michigan University. Irving P. Margulies, former HUD Associate General Counsel, and Cushing N. Dolbeare, consultant on housing programs and policies, discussed the paper.

The papers and the discussants' comments are contained in a supplement to this report (GAO/RCED-85-102S). Where appropriate, this material is incorporated in the text of this report. Finally, we had three housing and finance experts review and comment on portions of our draft report. These consultants were Robert Buckley, The Urban Institute; Anthony Sulvetta, Justin Research; and John C. Weicher, American Enterprise Institute.

Our review was performed in accordance with generally accepted government auditing standards. Our field work was done between July 1984 and February 1985. All data included are the most current available at the time our field work ended.

Data limitations

We do not have a statutory right of access to FNMA's records. Although FNMA was extremely cooperative in providing information available to the public and in furnishing several explanatory reports and special analyses, it would not provide us with a number of items important to meeting the review objectives. According to senior FNMA officials, these items are confidential information and their disclosure could potentially impair the firm's competitive position. Among data FNMA would not provide are

--FNMA's "Projected FNMA Financial Performance Sensitivity to Economic Conditions";

--detailed statistics related to foreclosure losses and time frames for the various aspects of foreclosing and selling homes in default;

--data underlying FNMA operating expenses or showing expenses and income by program that FNMA does not keep;

--breakdowns on individual mortgages with respect to interest rates, mortgage balances, and remaining terms; and

--consultant or contract fees and salaries for employees below the officer level.

HUD has statutory authority to access FNMA's records in furtherance of its regulatory responsibilities. During our review we requested certain information from HUD appropriate to its regulatory role. While HUD freely gave us access to FNMA-related information in its possession, it chose not to request the remaining information from FNMA for our use. Generally, these data related to information on individual loans purchased by FNMA in 1983 and 1984 and certain data on foreclosures and net loss experiences. To some extent we were able to use more aggregate data to compensate for specific data deficiencies. Instances in which such limitations affected our work are described wherever they occur in the text.

CHAPTER 2

DEVELOPMENT OF THE HOUSING FINANCE SYSTEM AND FNMA's ROLE

The housing finance system is a complex array of finance institutions using instruments with varying degrees of risk, maturity, and marketability. This system has evolved over the past one-half century to assist buyers of houses in financing their purchases. It is the result of a series of federal policies and laws establishing and regulating public and private lending institutions, mortgage insurance, and other services. High, volatile interest rates in the late 1970's and early 1980's created a financial crisis for savings and loans, FNMA, and other portfolio lenders. Though early legislation and regulation insulated mortgage finance from broader credit markets, changes beginning in 1978 have eliminated many of those provisions and integrated mortgage markets with general credit markets. A variety of deregulatory moves and innovations in the primary mortgage market has increased competition and enabled the savings and loan industry (thrifts) to better adjust to market conditions. These changes altered FNMA's activities in the secondary markets. FNMA did not, however, receive the broader asset powers (outside home lending) that were provided the thrifts.

KEY SECONDARY MARKET PARTICIPANTS

The rapidly growing secondary mortgage market is dominated by three principal mortgage financing entities: FNMA, a privately owned federally-chartered corporation; the Government National Mortgage Association (GNMA or "Ginnie Mae"), an agency of HUD; and the Federal Home Loan Mortgage Corporation (FHLMC or "Freddie Mac"), a privately owned but federally-sponsored company. In 1982 and 1983 these agencies' activities comprised more than 60 percent of the secondary mortgage market with private participants taking the rest. The private firms are playing a growing role in the market as mortgage-backed security issuers.

FNMA and GNMA took their present form as a result of 1968 legislation that partitioned the previous FNMA into its current configuration and created GNMA. FHLMC was chartered in 1970.

FNMA purchases mortgages from mortgage bankers and other lenders and holds the loans in its investment portfolio. The corporation finances those purchases by issuing debt in the form of debentures and notes of varying maturities. FNMA was originally authorized to purchase only FHA-insured and, in 1948, VA-guaranteed mortgages; but legislation in 1970 authorized FNMA to purchase conventional loans, which FNMA began doing in 1972. In 1981

the company began issuing mortgage-backed securities (MBSs),[1] guaranteed by FNMA with respect to full and timely payment of principal and interest. FNMA's MBS program has grown considerably since then, largely to satisfy lender demand for "swaps" (discussed below). However, FNMA purchases for portfolio still exceed those for mortgage-backed securities as shown in table 2.1.

Table 2.1

Secondary Market Purchases and Guaranteed Pools
by Federal and Federally Sponsored Credit Agencies
One-to-Four Family Houses
1976 - 1984
(in millions)

	FNMA		FHLMC		GNMA	
Year	Pools[a]	Port-folio[b]	Pools[a]	Port-folio[b]	Pools	Total agency activity
1976	--	$ 3,337	$ 1,762	$ 223	$13,086	$ 18,418
1977	--	4,650	4,633	523	16,795	26,601
1978	--	12,301	4,134	800	14,622	31,857
1979	--	10,798	3,605	734	24,072	39,209
1980	--	8,704	1,997	958	20,978	31,107
1981	717	6,113	3,207	322	13,315	23,675
1982	13,970	15,106	24,107	289	14,727	68,283
1983	13,079	17,543	20,482	4,898	49,354	105,356
1984						
2/q	5,413	8,751	5,663	1,996	14,542	36,365

[a]Includes swaps and nonswap securities.

[b]Includes portfolio acquisition held but later sold to mortgage pools.

Source: HUD Survey of Lending Activity and FNMA, FHLMC, and GNMA reported activity as compiled in the HUD Office of Financial Management periodic secondary mortgage market report, October 16, 1984.

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[1]Mortgage-backed securities are instruments representing undivided shares of groups of mortgages. MBSs are issued by GNMA, FHLMC, and private issuers. They differ in the types of mortgages backing them (FHA and VA or conventional); the guarantor provided (U.S. government, government-sponsored agency, or private insurer); and the manner of distributing principal and interest payments on the mortgages among investors (treating all investors as one class or separating them into categories distinguished by the rate at which they receive principal payments).

GNMA reports to HUD and guarantees securities based on pools of FHA and VA mortgages, a program it began in 1970. Because its guarantee for timely payment of principal and interest is backed by the full faith and credit of the United States, GNMA securities are more attractive to investors. Thus GNMA is able to compete successfully to include in pools most of the current production of FHA and VA mortgages, which are desirable by virtue of their government guarantee. GNMA does not currently purchase single-family mortgages.

FHLMC was chartered in 1970 to serve the member institutions of the FHLBB, primarily the federally insured savings and loan associations, by purchasing and selling conventional residential mortgages. (FHLMC last purchased FHA or VA loans in 1977.) Unlike FNMA, FHLMC has relatively small portfolio holdings and purchases mortgages primarily for inclusion in pools to back various types of security issues.

The other principal entities in the secondary market are thrifts and other mortgage originators, private conduits, life insurance companies, and pension funds. The development of mortgage-backed securities has drawn a growing number of fully private firms (or conduits) into the secondary market, beginning in 1975. These firms find it difficult to compete with the federally-sponsored agencies and therefore concentrate largely on the non-conforming market, i.e., on mortgages that exceed the ceiling (currently $115,300 on single-family homes) set by law on FNMA and FHLMC purchases. However, as discussed later in this chapter, the recently enacted Secondary Mortgage Market Enhancement Act may improve the competitive position of these private firms.

THE SYSTEM BEFORE DEREGULATION

The current housing finance system dates to the early 1930's, when a depression-induced liquidity crisis caused widespread mortgage foreclosures by lending agencies, primarily mutually owned building and loan societies and banks. Most mortgages were short term, with features now characterized as "creative financing" (for example, balloon and roll-over mortgages). Refinancing was often not available as these short-term mortgages came due. Widespread bank closures resulted because private insurers lacked the reserves needed to compensate lenders for massive foreclosure losses. In 1933 the Federal Deposit Insurance Corporation (FDIC) was established to insure the accounts of depositors in commercial banks and many mutual savings banks. The following year, Congress established the Federal Savings and Loan Insurance Corporation (FSLIC) to insure the accounts of depositors in S&Ls. Also in 1934 the National Housing Act established the Federal Housing Administration (FHA) to promote and insure long-term housing mortgages that called for borrowers to pay off the principal and interest of loans in full, in equal payments, over a specified number of years.

Because deposit and mortgage insurance established the federal government as final recourse for losses arising from the mortgage-lending process, savers were encouraged to place their funds in mortgage-lending institutions, and lenders faced reduced risks in making mortgage loans.

The 1934 National Housing Act also authorized the federal chartering of private mortgage associations. FNMA was incorporated in 1938 pursuant to title III of the act as a wholly owned subsidiary of the Reconstruction Finance Corporation. The purpose of the parent organization (known first as the National Mortgage Association of Washington and 2 months later renamed Federal National Mortgage Association) was to purchase, in the secondary market, private lenders' FHA-insured loans, thereby guaranteeing a source of funds and helping to prove the viability of long-term, self-amortizing loans. The finance system that developed in time featured long-term fixed-rate mortgage loans provided predominantly by the thrifts.

To hold down the cost of deposit accounts to thrift institutions--and consequently the interest rate charged on mortgages--the government began to regulate the interest rates that thrift institutions could pay on deposits. Federal Reserve Regulation Q, setting deposit account interest rate ceilings at commercial banks since 1936, was extended to accounts at savings and loan associations and mutual savings banks in 1966. The interest rate ceiling imposed on thrift institution deposits was set at a level slightly higher than the ceiling for accounts at commercial banks, in order to give mortgage-lending institutions an advantage in attracting deposits.

However, during 1966, 1969, 1974, and 1979, periods of sharp increases in interest rates and inflation, funds flowed out of the major mortgage lenders into unregulated instruments--as deposit interest became increasingly unattractive and consumers withdrew their deposits to obtain a higher return elsewhere. When the S&Ls withdrew from lending, FNMA, which was not dependent on deposits for funds, became more significant in attracting nontraditional funds to housing.

In the 1966 credit crunch, FNMA increased its mortgage purchases to over $2 billion, over four times the previous year's and about 34 percent above its previous high. When the company assumed its present form in 1968 (see ch. 1), its portfolio stood at $7.2 billion. During the 1969 credit crunch, the corporation purchased over $4.2 billion of mortgages. In the 1973-1974 credit crunch, FNMA again increased its purchases--to $6.3 billion in 1973 and $7 billion in 1974 as compared to approximately $4 billion in 1971 and 1972; and its portfolio grew by over $9 billion to $29.7 billion.

Figure 2.1

Housing Finance Deregulation Legislation

Legislation and Date Enacted	Provisions
Depository Institutions Deregulation and Monetary Control Act of 1980--March 31, 1980	Extended savings interest rate control for all depository institutions and the thrift institution differential for six years. Shifted rate-setting authority from individual agencies to a Depository Institutions Deregulation Committee. Increased FSLIC and FDIC insurance for individually owned savings accounts from $40,000 to $100,000. Extended the federal override of state usury ceilings on certain mortgage and other loans. Authorized nationwide NOW accounts effective at year-end 1980 and established levels of reserves that must be held against NOW balances. Authorized investment of up to 20 percent of assets of federal associations in consumer loans, corporate debt securities, and commercial paper. Eased or removed lending restrictions, including geographical limitations, loan-to-value ratios, and treatment of single-family loans exceeding specified dollar amounts.
Garn-St. Germain Depository Institutions Act of 1982--October 15, 1982	Provided capital assistance through net worth certificates to financially weak depository institutions that have suffered earnings and capital losses. Mandated the creation of a deposit instrument equivalent to money market mutual funds. Advanced the deadline to eliminate interest rate differentials from March 31, 1986, to January 1, 1984. Provided expanded authority to make commercial, agricultural, and corporate loans to federal savings and loans and mutual savings banks. Authorized the change between chartering status as a federal savings and loan and a federal savings bank and/or between the stock and mutual form of chartering. Authorized FNMA to issue preferred stock and made such stock freely transferable. Overrode state "due-on-sale" laws.
Secondary Mortgage Market Enhancement Act of 1984 --October 3, 1984	Removed some disadvantages of private securitizers relative to government agencies by exempting them from state security law registration and making their securities legal investments for state-chartered banks, insurance companies, public and private pension funds.

DEREGULATION ENHANCES COMPETITION

A series of deregulatory moves, beginning in 1978, permitted mortgage-lending institutions to compete more effectively for funds. (Figure 2.1 describes three significant laws.) As a first major step, regulators authorized regulated institutions to offer money market time deposit certificates with interest rates tied to 6-month Treasury bills. These "money market certificates" required a $10,000 minimum deposit for a 6-month period. (The thrifts were authorized to pay 1/4 of 1 percent more than commercial banks but, effective March 1979, that differential was eliminated when the Treasury bill rate exceeded 9 percent.) In January 1980 financial institutions were also authorized to offer variable-ceiling deposits, "small saver certificates" (SSCs), with maturities of at least 2-1/2 years. (A temporary 12-percent interest-rate ceiling placed on these accounts in March 1980 effectively made them below-market accounts. In August 1981, SSCs were fully deregulated.)

The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 transferred authority to set maximum interest rates on deposits to the Depository Institutions Deregulatory Committee (DIDC). The act also provided for scheduled removal of interest rate ceilings on deposits. However, the financial condition of the thrifts continued to deteriorate as net deposit account withdrawals at S&Ls rose to $25.4 billion in 1981 and were $6.4 billion in 1982. As borrowing costs outstripped low-interest portfolio yields and higher yields on new mortgages depressed the value of older portfolio holdings, the industry's net worth plummeted, and a wave of mergers, largely mandated by the FSLIC, followed.

However, two important developments late in 1981 made it feasible for S&Ls either to sell their mortgages or exchange them for more liquid mortgage pass-through securities. One was a 1981 Federal Home Loan Bank Board regulation allowing FSLIC-insured S&Ls to defer losses from mortgage sales under regulatory accounting principles. This allowed S&Ls to improve their liquidity without immediate substantial reductions to their net worth. The other development was the initiation of mortgage "swaps" programs first by FHLMC and then by FNMA. A swap is an exchange of the mortgages of an S&L, mutual savings bank, or commercial bank at face value for securities guaranteed by FNMA or FHLMC and backed by the mortgages being exchanged. The mortgage lender swapping the mortgage receives a more liquid security while the security issuer holds the mortgage. Swaps permitted the S&Ls to continue to service the swapped mortgages (earning fee income) and to count them as investments qualifying for their special bad-debt-reserve eligibility. Also because swaps involved an exchange of assets of like value, the S&Ls had no balance-sheet loss if they retained the securities. Finally, the swaps improved the liquidity of S&Ls because the agency securities could be counted as collateral in financial transactions.

Both the S&Ls and FNMA used the opportunities these two developments offered. The S&Ls sold $50.8 billion of mortgages in 1982 and $50.2 billion in 1983. FNMA increased its mortgage backed securities activity from less than $750 million in 1981 (its first year to issue MBSs) to $14.0 billion in 1982 and $13.3 billion in 1983, with 78 percent and 68 percent respectively for swaps. FNMA's swaps in 1982 primarily involved seasoned (i.e., old low-yield) mortgages, and about half the FNMA swaps in 1983 involved seasoned mortgages. FNMA also stepped up its purchases for portfolio. These increased from a 4-year low of $6.1 billion in 1981 to $15.1 billion in 1982.

In 1982 Congress, by passing the Garn-St. Germain Act, accelerated the process of deregulation. This act provided thrifts still further lending powers and increased thrifts' ability to compete for funds by offering money market funds. In addition, the act accelerated removing the remains of Regulation Q; also DIDC permitted new types of deposits, including the payment of interest on most household checking accounts. These events, combined with a drop in market interest rates, allowed new deposit flows into FSLIC-insured S&Ls to reach an estimated $62.8 billion by 1983, a record level.

Lenders acquired new investment options

Deregulation of the thrifts with respect to the interest rates they could pay enabled them to compete more effectively for funds. However, as those interest rates escalated, their cost exceeded the S&Ls' income from their portfolios of fixed-rate, long-term mortgages. It became apparent that in a market of unpredictably rising interest rates, S&Ls would need authorization to diversify their assets. To enable thrifts to better match the maturity and yields of their assets with those of their liabilities, they were granted investment options that included various nonmortgage investments as well as considerably increased mortgage-lending authority. Although FNMA faced similar financial strains, its asset powers were not extended outside the home mortgage market.

This increased investment authority was an important emphasis of the Garn-St. Germain Act that, building upon authorization begun in 1980, expanded S&L authority to invest in nonmortgage investments. It permitted the thrifts to invest a portion of their assets in consumer, agricultural, commercial, and corporate loans.

On the other hand, the S&Ls had also acquired a variety of new options with respect to mortgage lending. In 1980 the federal government preempted state usury ceilings on mortgage interest rates for first mortgages. The following year the Federal Home Loan Bank Board authorized adjustable rate mortgages for federal associations. The Garn-St. Germain Act authorized non-federally chartered lending institutions to offer alternative types of

mortgages. The S&Ls were also authorized to invest in options and futures to hedge against adverse movements in interest rates--that is, to protect their financial positions by optional positions with opposite interest movement.

Moreover, the thrifts retained a tax incentive to invest in mortgages. Thus the thrifts could continue to use excess bad-debt reserves to offset up to 40 percent of their taxable income, if they maintained at least 82 percent (72 percent for mutual savings banks) of their assets in residential mortgages. The Tax Equity and Fiscal Responsibility Act of 1982 reduced the bad-debt write-off to 34 percent.

The new mortgage instruments also addressed a problem relating to higher interest costs resulting from deregulation, namely borrower resistance to high interest rate mortgages as lenders passed through their higher interest costs. In the late 1970's, therefore, mortgage originators received authorization to make loans with other than fixed rates and level payments. Beginning in 1979 S&Ls and mutual savings banks could make graduated payment mortgages (GPMs) featuring payment schedules that increased gradually from low starting payments.

Approval of ARMs benefits portfolio investors

In 1981, the Federal Home Loan Bank Board and the Comptroller of the Currency implemented regulations permitting federally chartered lenders to originate, purchase, and hold adjustable rate mortgages (ARMs). To grant parity to state institutions Garn-St. Germain authorized them to offer alternative types of mortgages as well. ARMs, like GPMs, aim to qualify homebuyers for houses from which lending guidelines would otherwise preclude them, principally by keeping payments low in early years. Unlike GPMs, however, ARMs are designed to provide the lender a rate of return that follows market rates, thus shifting a portion of the interest rate risk to the homebuyer in return for lower initial rates and assumability of the loan. ARMs also have the effect of changing a long-term mortgage portfolio into the equivalent of a portfolio of shorter-term assets; thus the ARMs provide thrifts with assets that better match their liabilities (deposits) with respect to both interest rate and maturity. The approval of ARMs indirectly benefited FNMA and other secondary market portfolio investors.

Lenders were able to offer ARMs at rates acceptable to buyers because short-term market interest rates were much lower than long-term rates. In addition, the thrifts also offered first-year discounts of several percent, the "teasers" to make ARMs attractive to borrowers. Thus the thrifts were able to overcome homebuyers' preference for fixed-rate mortgages by offering ARMs at appreciably lower starting interest than the rate on fixed-rate mortgages. This is a condition that, according to the Director of HUD's Financial Policy Division, is not likely to be met if

short-term interest rates draw closer to long-term rates. Also, if higher foreclosure rates cause mortgage insurers to raise their insurance premiums on ARMs significantly, we believe those higher insurance rates may further reduce ARM's borrower appeal relative to fixed-rate mortgages.

DEVELOPMENT OF THE PRIVATE MBS MARKET

The development of mortgage-backed securities (MBS) has drawn a growing number of fully private firms into the secondary market. Just a few years after GNMA and FHLMC began to pool mortgages in 1970 and 1971, Salomon Brothers and the Bank of America pioneered the first privately developed mortgage-backed security in 1977. FNMA began issuing mortgage-backed securities in 1981.

Though private firms have issued securities based upon pools of mortgages, much of the private activity consists of what are known as collateralized-mortgage obligations. These are actually serialized bonds usually using previously issued MBS guaranteed by FHLMC, FNMA, or GNMA as the underlying security. They are bonds that provide separate short, intermediate, and long maturity classes. As mortgages in the pool are repaid, the proceeds are channeled first to the shortest maturity-class investors. Only when these have been repaid, do principal payments and prepayments go to the intermediate-maturity class. Investors in the long-maturity class are repaid last.

Through 1983 the private sector had originated a total of only about $7 billion of publicy offered mortgage-backed securities and collateralized-mortgage obligations and serialized bonds. But in the first quarter of 1984 alone, public issues by private firms totaled about $4.6 billion, mostly mortgage-collateralized securities, and accounted for about 20 percent of all mortgage-backed securities issued during the quarter. It should be noted, however, that the great majority of private mortgage-collateralized securities were collateralized by MBSs bearing a GNMA, FNMA, or FHLMC guarantee.

Data available on 1984 issues by private firms represent primarily their public issues. Inclusion of private placements would approximately double the number, according to a vice president and economist in Salomon Brothers' Bond Market Research Department. Moreover, recent legislation, most notably the comprehensive Secondary Mortgage Market Enhancement Act of 1984, removes some of private securitizers' disadvantages relative to the government-related firms, particularly with regard to extending delayed delivery to 180 days, exempting the private firms from registration under state security laws, and making them legal investments for state-chartered banks, insurance companies, and pension funds.

SUMMARY

Between 1978 and 1983 the mortgage finance system had acquired regulatory relief in four ways. First, deregulation of deposit interest rates had provided thrifts with access to funds, albeit at higher interest rates. Second, authorization to issue a variety of mortgage instruments (including different types of ARMs) had provided the principal mortgage investors--FNMA and S&Ls--with access to assets that would more nearly match liabilities with respect to yield and maturity. S&L's were also given authority to increase the proportion of non-housing assets in their portfolios. Third, swaps through FNMA and FHLMC had given mortgage lenders a channel for exchanging their large volume of low-yield, illiquid mortgages for a liquid mortgage-backed security without reporting a loss on the transaction. And finally, a growing variety of mortgage securities offered a product mix aimed to meet the cash-flow needs of various types of investors.

The subsequent chapters explore how FNMA adapted its activity in the face of these changes. It is significant to note, however, that FNMA's investment powers were not expanded beyond housing loans to help the company offset higher debt costs. Thus, FNMA stressed the development and acquisition of new home mortgage products and securities to accomodate changes in the primary market, generate income to offset its severe portfolio losses, and begin restructuring its portfolio.

CHAPTER 3

FNMA PROFITABILITY AND INTEREST RATE RISK

After 13 profitable years, FNMA reported losses in 1981 and 1982 and again in 1984. The primary determinant of FNMA's profits and losses was its interest margin, i.e., the difference between the interest FNMA earned on its mortgages and other assets it held and the interest FNMA paid on the money it borrowed to purchase and refinance its assets. However, in the 1981-1984 period, such factors as fee income, gains on the sale of mortgages, provisions for foreclosure losses, and administrative expenses were also significant determinants of FNMA's total profits or losses. While FNMA management's efforts to remain profitable may reduce the likelihood of government intervention, they have increased the size of its portfolio and the magnitude of financial assistance that the federal government might have to provide should FNMA encounter serious financial difficulties brought on by an extended period of higher interest rates.

Since it was chartered in its present form in 1968, FNMA has consistently held a portfolio dominated by long-term mortgages and financed it with debt that has much shorter maturities. As long as interest rates remained relatively stable and short-term rates were less than long-term rates, FNMA generally had a positive interest margin that enabled it to earn a profit from 1968 through 1980. As interest rates rose in 1980 and 1981, FNMA had to pay much higher interest rates as it refinanced its debt. But the interest FNMA earned on the mortgages already in its portfolio remained constant. As a result FNMA generally had a negative interest margin in the 1981-1984 period.

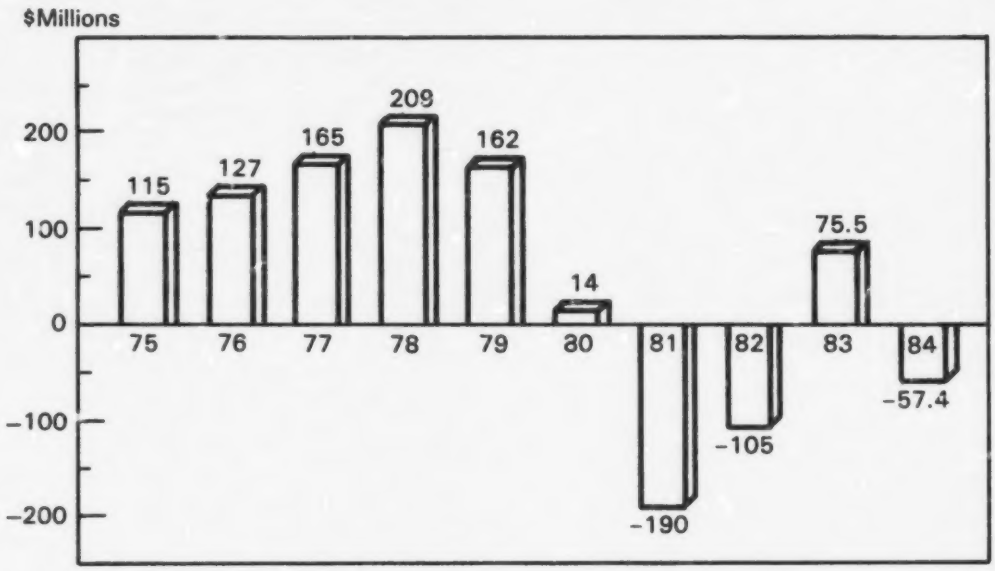
As long as the average cost of FNMA's debt exceeds the average yield on the mortgages FNMA purchased before 1981, FNMA must earn other income to offset the negative interest margin on this "old portfolio" if FNMA is to be profitable. Since 1981 FNMA has been attempting to do this in two ways: (1) by increasing fee income and (2) by earning money from the positive interest margin on mortgages purchased in 1981 and later years.

FNMA has been successful in doing both, although this success was partially offset by record foreclosure losses in 1983-1984. In addition, FNMA also undertook a strategy of more closely matching the maturities of its assets and liabilities, but its ability to do so is limited by its need to generate income to offset losses on its old portfolio.

FNMA's FINANCIAL PERFORMANCE (1975-1984)

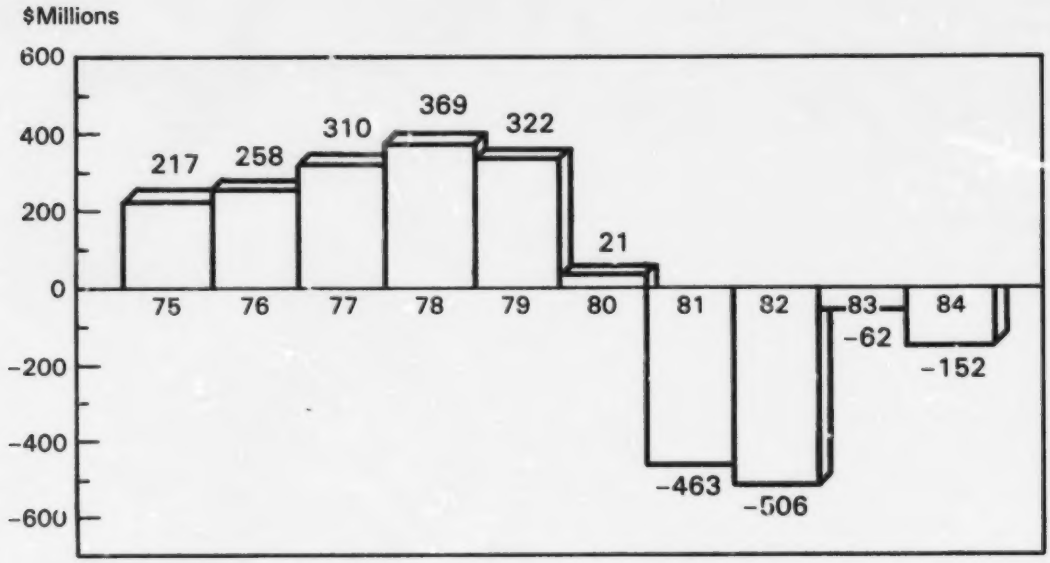
In 1978 FNMA reported record net income of $209 million. Three years later in 1981, FNMA reported a record net loss of $190 million as shown in figure 3.1. The major reason for the reversal in FNMA profits was the rapid rise in interest rates during this period. This greatly increased FNMA interest payments as it refinanced its debt. FNMA's cost of new borrowing and refinancing rose from 8.49 percent in 1978 to 16.22 percent in 1981. As a result, net interest margin declined from $369 million in 1978 to a negative $463 million in 1981, as shown in figure 3.2. The profit in 1983 was greatly influenced by a decline in interest rates and by the sale of a large block of market-rate mortgages that resulted in a $91 million gain.

Figure 3.1
FNMA Net Income (1975-1984)



Source: FNMA annual reports, 1975-1984

Figure 3.2
FNMA Net Interest Income Margin
As Reported
1975-1984



Source: FNMA Annual Reports for Years Ending 1975 through 1983 and FNMA Memorandum to Investors and Financial Analysts Fourth Quarter 1984

FNMA efforts toward profitability

After 1981 three major efforts to offset the negative interest margin, return FNMA to profitability, and reduce its long-term risk were undertaken. These were (1) to purchase a large volume of high-yielding mortgages, (2) to increase fee income and (3) to better match the expected maturities of its assets and liabilities. The first two are discussed here and the third, which is really aimed at reducing risk, is discussed later in the chapter under asset and liability management. FNMA's purchase of high-yielding mortgages financed by borrowing at lower interest rates generated a positive interest rate margin on new purchases compared to new debt beginning in 1982 (see table 3.1). Thus, FNMA figures that the positive interest margin it earns from purchasing these mortgages will reduce significantly the negative interest margin FNMA is incurring on older mortgages.

Table 3.1

Difference in Average Interest Rates Between Mortgage Purchases and New Debt Issues (1975-1984)

Year	New Debt Issued (percent)	Mortgages Purchased[a] (percent) (net yield)	Difference (percent)
1975	7.36	8.58	1.22
1976	6.86	8.70	1.84
1977	6.89	8.43	1.54
1978	8.49	9.09	.60
1979	10.72	10.11	-.61
1980	13.37	12.27	-1.10
1981	16.22	15.38	-.84
1982	12.82	15.00	2.18
1983	10.07	12.65	2.58
1984	11.47	12.79	1.32

[a]Average interest rates for mortgages purchased are net of servicing fees.

Source: FNMA annual reports 1975 through 1984; FNMA "Guide to Debt Securities" (March 1985).

Due to the impact of these purchases, FNMA's average portfolio yield increased in 1982 by 0.88 percent, more than it had increased in any of the preceding 6 years. Since FNMA's average debt cost declined slightly that year, the yield spread between the two declined from -1.57 to -0.65 percent and did not vary greatly from that in 1983 and 1984 as shown in table 3.2.

Table 3.2

Average Interest Rate Yields
End of Year Averages
1975-1984

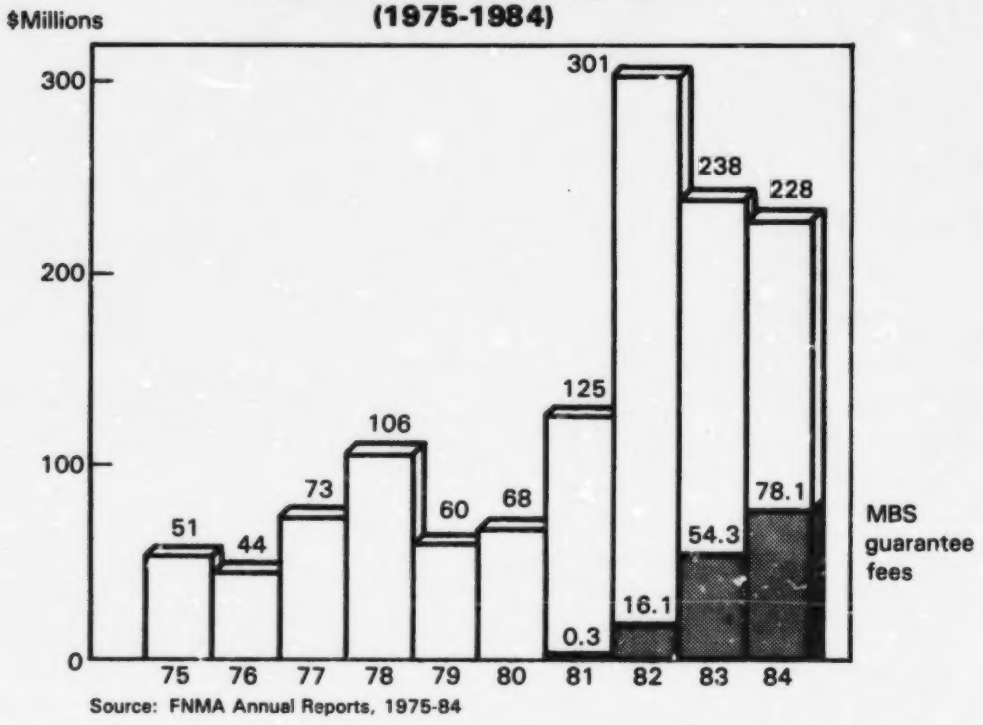
Year	Debt Outstanding	Mortgage Portfolio (net yield)	Difference
1975	7.45	7.87	.42
1976	7.46	8.01	.55
1977	7.52	8.09	.57
1978	8.05	8.39	.34
1979	8.81	8.75	-.06
1980	10.11	9.24	-.87
1981	11.42	9.85	-1.57
1982	11.38	10.73	-.65
1983	11.12	10.70	-.42
1984	11.56	10.93	-.63

Source: FNMA annual reports 1975-1984; FNMA "Guide to Debt Securities" (March 1985).

The second major effort initiated by FNMA in 1981 was to increase fee income. These fees were primarily earned by (1) guaranteeing the timely payment of interest and principal due on the underlying mortgages in the MBSs that it issues and guarantees and (2) selling loan commitments. In a loan commitment FNMA agrees to buy a specified quantity of mortgages on a particular date, and the mortgage seller pays FNMA a fee for this commitment.

As figure 3.3 shows, this fee income has risen dramatically since 1981. Loan commitment fees continue to be the predominant source of fee income. However, MBS fees have risen rapidly since FNMA began its MBS program in 1981. Commitment fee income is closely correlated to the annual volume of mortgages purchased by FNMA. For example, commitment fee income has been high in the 1982-1984 period, reflecting the high annual volume of mortgages FNMA has purchased. Total fee income has helped to offset FNMA's negative interest margin.

Figure 3.3
Total Fee Income as Reported
(1975-1984)



Source: FNMA Annual Reports, 1975-84

However, FNMA suffered losses in 1981, 1982 and 1984 as three other factors discussed below had an increasing impact on FNMA profitability.

OTHER FACTORS AFFECTING PROFITABILITY

Although the interest margin and fee income are the two factors that have most consistently and significantly affected profitability since 1980, four other factors were important during the 1981-1984 period. These include sales of mortgages from portfolio, foreclosure loss reserves, administrative costs, and a favorable change in the federal tax treatment of losses. The latter item is discussed in chapter 5.

Sales of mortgages

When mortgage interest rates decline, FNMA has the opportunity to profit by selling mortgages from its portfolio that have higher interest rates than the current interest rate. FNMA did this in the 1982-1984 period as shown in table 3.3.

Table 3.3

FNMA Mortgage Sales and Profits
1975-1984
(dollars in millions)

Year	Value of Mortgages Sold	Profits (Loss) from Sale
1975	2.0	a
1976	86.1	(2.9)
1977	81.6	(5.9)
1978	9.0	a
1979	21.8	(1.7)
1980	.6	a
1981	9.3	0.2
1982	3,021.0	44.4
1983	4,467.5	90.7
1984	979.0	11.7

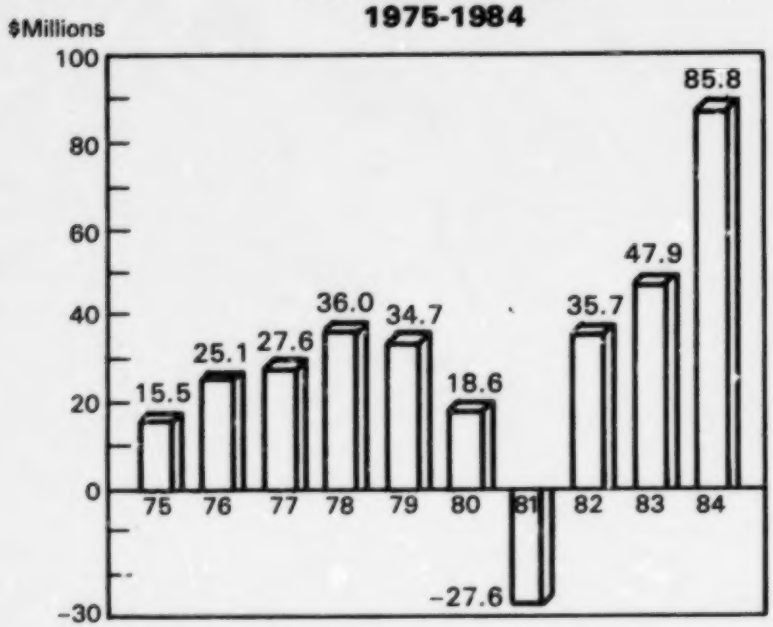
[a]Less than $50,000

Source: FNMA annual reports, 1975-1984.

Foreclosure loss reserves

Mortgage foreclosures result in a loss to FNMA to the degree these losses exceed mortgage insurance payments to FNMA. FNMA sets aside a reserve for these losses at the time it purchases the mortgages. The provision for loss reduces income in the period recorded. Figure 3.4 shows the trend in the provision for losses from 1975 through 1984. As illustrated, FNMA has increased the provision for loss in the past 3 years due primarily to an increased volume of mortgage purchases and a one-time adjustment of $35 million to replenish its reserves in 1984 due to increased foreclosure losses. Chapter 4 discusses FNMA's experience with foreclosures in detail.

Figure 3.4
FNMA
Provision for Losses
1975-1984



Source: FNMA Annual Reports, 1975-84

Administrative costs

FNMA administrative costs increased gradually from 1975 through 1981. However, in the next 3 years, administrative costs increased 126 percent. FNMA management informed us that information on the components of its administrative costs was not publicly available and would not provide it to us. For example, FNMA would not provide advertising, entertainment, or consultant expenses or provide us the names of its consultant firms.[1] FNMA would not provide information on salary levels of employees except that which is already publicly available from sources such as its annual report and proxy statements. It did provide the results from a consultant's study comparing these executive salaries to those of other financial institutions and which found that these salaries were generally in line with others in the industry. Finally, the only information FNMA would provide related to administrative expense was that contained in the U.S. budget and shown in table 3.4 on the next page. FNMA would not define the individual line items in table 3.4 nor tell us what specific items were included in each.

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[1]FNMA's shareholders have voted repeatedly not to disclose the names or compensation of its consultants.

Table 3.4

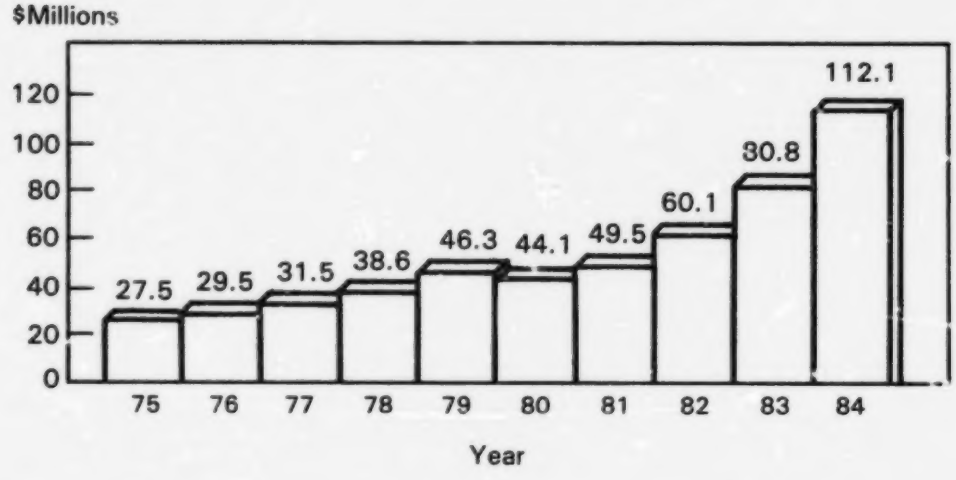
Expenses of the Federal National Mortgage Association
(in millions of dollars)

	1983	1984
Personnel compensation	37	47
Personnel benefits	10	15
Travel and transportation of persons	2	4
Communications, utilities, and other rent	3	4
Printing and reproduction	3	5
Supplies and materials	1	1
Building and equipment costs	10	14
Other services	11	17
Interest in borrowing from the public	7,913	8,658
Investments and loans	17,146	15,894
Mortgage servicing fees	219	211
Other costs	-103	-20
Change in resources (undelivered orders)	97	-449
Total obligations	25,349	24,401

Source: U.S. budget (FY-1985, FY-1986)

FNMA officials did attribute about $30 million of the increase in administrative costs to a new information system that they are installing and that they believe will provide them with a technical advantage in the secondary markets. Figure 3.5 illustrates the growth of administrative costs over the period 1975 through 1984.

Figure 3.5
FNMA Administrative Costs
1975-1984



Source: FNMA Annual Reports, 1975-84

FNMA officials said that the "administrative costs as a percent of the value of the portfolio plus the MBSs guaranteed" is the relevant figure for assessing the magnitude of administrative costs. As shown in table 3.5, the figure was stable or declined through 1982 and then rose in 1983 and 1984.

Table 3.5
FNMA Administrative Cost as a Percent of the Value of the Portfolio Plus MBSs Guaranteed

1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
.09	.09	.09	.09	.09	.08	.08	.07	.08	.09

FNMA's MANAGEMENT OF ASSETS AND LIABILITIES

FNMA's management informed us that its policy in acquiring assets and issuing debt is to select the types and maturities of each that will allow it to strike a balance between the goals of earning a profit for the corporation and reducing interest rate risk. This means that FNMA attempts to better match the maturities of its new assets and liabilities, and thereby reduce its interest rate risk,[2] to the degree that earnings allow FNMA to do so. The two goals conflict, at least in the short run, because if FNMA perfectly matched the maturities of new debts and assets, and thereby substantially reducing interest rate risk, FNMA would earn a positive interest margin on new assets that would be far too small to offset the current negative interest margin on FNMA's old portfolio. As a result FNMA would lose money each year. On the other hand, if FNMA maximized the interest margin on new assets by acquiring only long-term, high-yield assets and financing them all with short-term debt, this would generate higher profits while creating a severe maturity mismatch between new assets and liabilities and increase its interest rate risk. Figure 3.6, an upward sloping yield curve,[3] shows the positive interest margin that can be earned if this strategy were employed.

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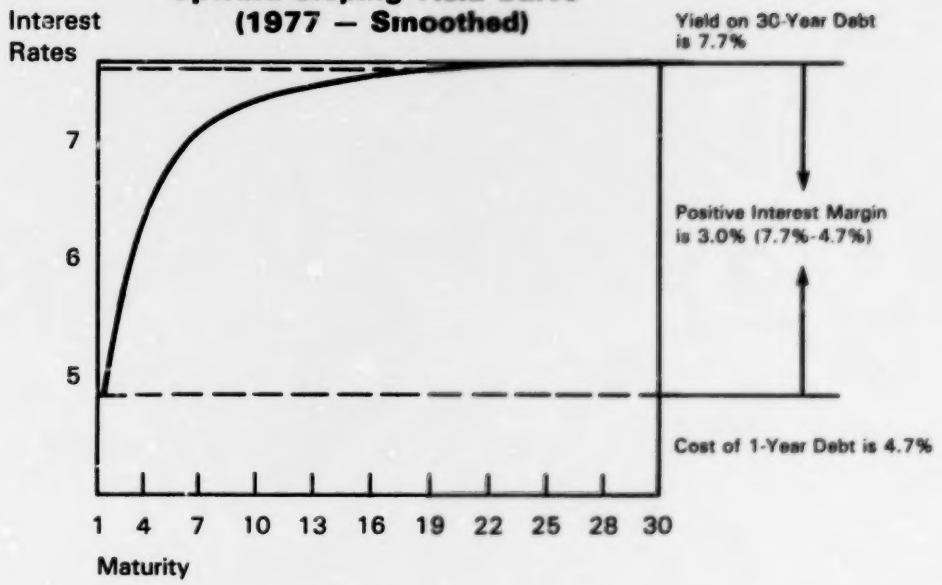
[2]Interest rate risk is the risk that an increase in interest rates will lower the value of fixed-rate securities such as mortgages and debentures. The magnitude of the change in value increases with the term to maturity of the security.

[3]A yield curve shows the relationship between interest rates and the maturity of debt. The upward sloping curve has been typical of the last three decades.

Figure 3.6
Upward Sloping Yield Curve
(1977 — Smoothed)

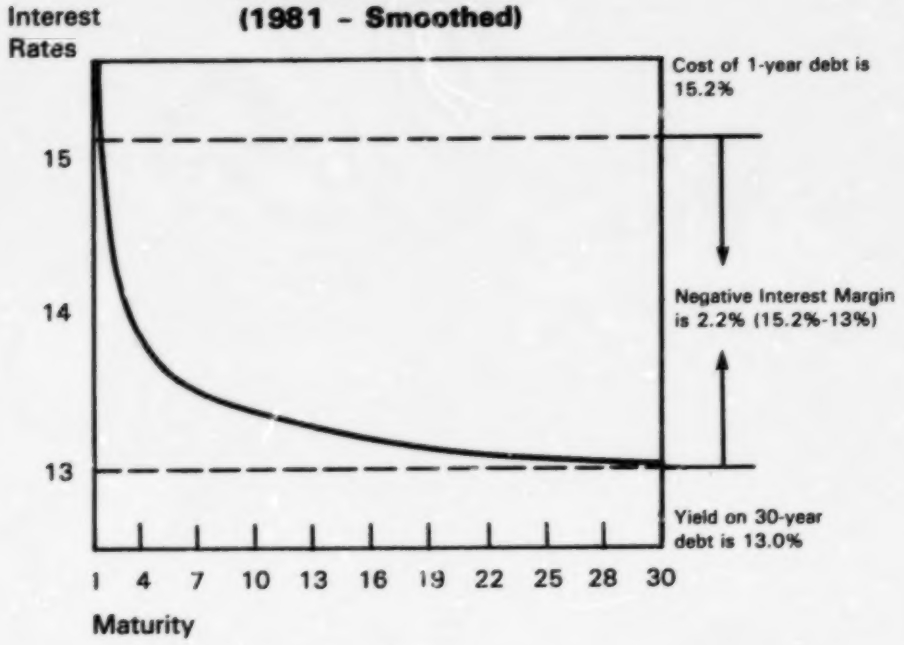


The upward sloping curve means that most investors either prefer to hold more liquid and less risky short-term assets or are anticipating higher interest rates and are willing to hold short-term debt that can be reinvested if rates rise. Otherwise, all investors would prefer higher long-term yields. Thus, FNMA is calculating that interest rates will not soon rise above the yield on new assets when it borrows short to lend long.

In addition FNMA's perceived agency status allows it to take this risk because FNMA can borrow at favorable rates reflecting little risk. Without this perceived agency status FNMA would pay much higher rates to incur such risks and could not profitably invest in mortgages.

If the yield curve shifts upward and/or becomes downward sloping (inverted) (see figure 3.7), FNMA must refinance its short-term debt at a higher interest rate. In the example shown in figure 3.7, the cost of 1-year debt is 15.2 percent and exceeds the 13.0-percent yield on 30-year mortgages, resulting in a negative interest margin of 2.2 percent. In addition, the yield curve shifted upward in 1981 compared to 1977. As a result, the cost of all maturities of debt in 1981 exceeded the 7.7 percent that 30-year mortgages yielded in 1977 as shown in figure 3.6. Thus, refinancing the debt used to purchase the 1977 mortgages resulted in a very substantial negative interest margin for those mortgages.

Figure 3.7
Inverted Yield Curve
(1981 - Smoothed)



Asset management

To shorten the maturity of its assets and reduce its interest rate risk, FNMA has purchased sizeable amounts of (1) shorter-term, fixed-rate second mortgages and (2) ARMs whose yields rise and fall with some interest rate index. FNMA has also increased the volume of mortgage-backed securities that it guarantees that have no interest rate risk for FNMA but generate fee income each year. This fee income helps mitigate interest rate risk in that it provides a steady source of income that can be used to partially offset the negative interest margin that results from higher interest rates. FNMA management said FNMA has also lowered the price it pays for FHA/VA mortgages because they are assumable and will tend to have a longer maturity than conventional mortgages. They also said that, as a result, FNMA has virtually stopped purchasing FHA/VA mortgages because GNMA prices are more competitive. These changes in FNMA's portfolio are shown in table 3.6.

Table 3.6
FNMA Mortgage Portfolio
(dollars in billions)

End of period	FHA/VA	Fixed-rate conventional	Second mortgage	ARM	Multifamily	Total portfolio[a]
1975	23.3	2.5	-	-	6.1	31.9
1976	22.2	4.8	-	-	6.0	32.9
1977	21.9	6.6	-	-	5.9	34.4
1978	26.1	11.5	-	-	5.7	43.3
1979	29.4	16.1	-	-	5.6	51.1
1980	33.4	18.4	-	-	5.6	57.3
1981	34.5	21.2	.2	.1	5.4	61.4
1982	33.7	27.8	1.6	3.3	5.3	71.8
1983	31.0	32.5	2.4	7.1	5.2	78.3
1984	29.0	38.7	2.8	11.7	5.8	87.9

[a]Totals may differ due to rounding.

Source: FNMA annual reports 1975 through 1984; FNMA "Guide to Debt Securities" (March 1985).

FNMA shortened the average maturity of its assets by adding ARMs and second mortgages to its portfolio, but FNMA holdings of fixed-rate, long-term mortgages have continued to increase (though decreasing as a percentage of portfolio). These mortgages accounted for about half ($15.9 billion) of the net portfolio increase ($30.6 billion) in the 1981-1984 period.

Liability management

FNMA has had to refinance increasingly larger amounts of debt each year since 1977 to maintain and expand its portfolio of mortgages. Figure 3.8 shows that FNMA debt due within one year, as a percent of total outstanding debt, rose from 17.6 percent at the end of 1977 to a new high of 37.4 percent at the end of 1984.[4] In the same period the amount of this debt rose from $5.6 billion to $31.3 billion. This has increased the sensitivity of FNMA earnings to interest rate changes. If interest rates rise, the $31.3 billion in debt due within a year will have to be paid off and reborrowed at a higher interest rate, adversely affecting FNMA's interest margin. This is a problem that has occurred in the past as described in FNMA "Guide to Debt Securities" of March 7, 1985:

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[4]FNMA officials said they expect this percent to decline in 1986 and later years because they had issued substantial amounts of intermediate-term debt (1-7 years to maturity) in 1984.

"In the 1980s, the environment in which the Corporation operates changed dramatically. In 1980, and again in 1981, interest rates rose sharply to unprecedented levels. In this environment, the mismatch in the maturity structures of the Corporation's asset and debt portfolios became the Corporation's major financial problem. Significant amounts of maturing debt had to be refinanced at much higher costs, while repayment of assets was much slower. The increase in yield on the mortgage portfolio did not keep pace with the sharp increase in the average cost of outstanding debt. The result was greatly reduced profits in 1980 and substantial losses in 1981 and 1982."

Debt maturing in 1985 ($31.3 billion) as of December 31, 1984, is twice the amount that matured in 1981 ($15.5 billion) as of December 31, 1980. Should interest rates fall, the $31.3 billion of debt due within 1 year can be paid off and reborrowed at a lower interest rate that will positively affect FNMA's interest margin.

FNMA data show that of the debt due after 1 year, outstanding as of December 31, 1984, about $13.3 billion will be refinanced in 1986; $17.0 billion, in 1987; and $9.9 billion, in 1988. However the total refinancing needed in these years could be much greater, depending on the maturities of the debt refinanced in 1985 and succeeding years and on the amount and maturities of additional debt FNMA issues in those years to finance the continued expansion of its portfolio.

Although debt due within 1 year has accounted for an increasingly larger portion of FNMA debt structure in recent years, the average maturity of FNMA total debt actually increased slightly in 1983 and 1984 as shown in table 3.7.

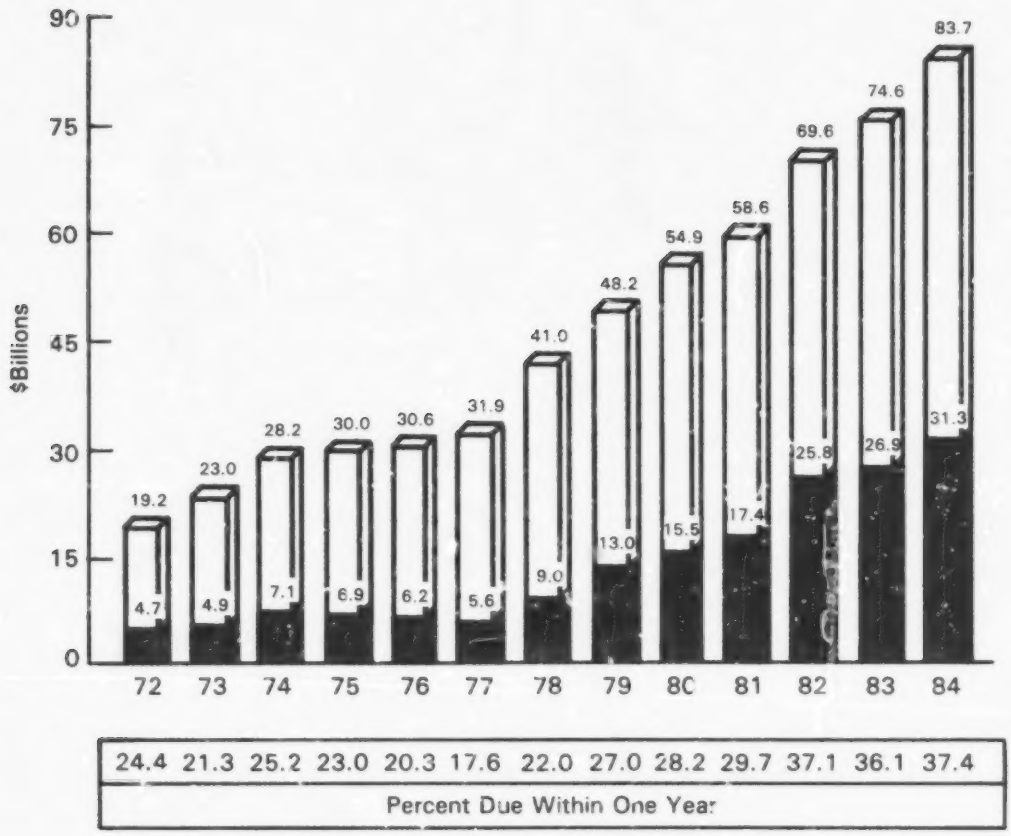
Table 3.7

Average Maturity of FNMA Debt

Year	1977	1978	1979	1980	1981	1982	1983	1984
Average maturity in months	53	45	39	35	31	27	29	31

Source: FNMA annual reports 1977 through 1984

Figure 3.8
Federal National Mortgage Association Bonds, Notes, Debentures, Net Year Ending Balance as Reported (1972-1984)



Source: FNMA Annual Report and Fourth Quarter Analysts Pack for Investors and Analysts

This resulted from FNMA's increased issuance of intermediate term debt and sale of some very long-term debt in 1983 and 1984 whose impact on the average debt maturity would be substantial despite the fact that the amount of such debt was small. For example, in 1984 FNMA issued $250 million of 30-year debentures with a 10-year call provision. Also in 1984 FNMA issued a 30-year zero coupon debenture (with interest paid in one final lump sum rather than periodically) and a 35-year zero coupon subordinated capital debenture (final lump-sum interest payment made after payments to holders of non-subordinated debentures). These produced net proceeds of $209.6 million and $206.4 million, respectively.

In summary, during the 1981-1984 period, FNMA (1) added $14.5 billion of ARMs and second mortgages to its portfolio to reduce the average maturity of its assets, (2) issued sufficient intermediate and long-term debt in 1983 and 1984 to raise the average debt maturity to 31 months after it dropped from 53 months in 1977 to 27 months in 1982, (3) increased its holdings of long-term, fixed-rate mortgages by $16.1 billion, and (4) doubled its debt due within one year. These actions suggest that FNMA's primary emphasis--especially in 1981 and 1982--was on increasing current year profits (or reducing losses) by buying long-term assets and financing them with short-term debt. This is not surprising considering that FNMA lost money in 3 of the 4 years in the period and had little opportunity to forego current year profits in order to more closely match the maturities of assets and liabilities. However, FNMA did increase its short-term assets by $14.5 billion during the period. Thus, where the average maturity mismatch of assets and liabilities may have declined, the magnitude of long-term assets and liabilities due within one year has significantly increased. However, any extended period of lower or even stable interest rates should allow FNMA to make more substantial progress in alleviating this maturity mismatch and still operate profitably.

FORM OF POTENTIAL FEDERAL ASSISTANCE FOR FNMA

There is a perception in the credit markets that the federal government would step in and provide financial assistance should it be necessary to allow FNMA to continue operations. Although such financial assistance is limited by statute to purchasing $2.25 billion of FNMA debt obligations, investors generally assume that the potential impact of a default by FNMA would have such disruptive effects on the financial system that the federal government would provide much greater support if necessary to prevent a FNMA default.

The form and amount of any federal assistance needed would probably be that which could be provided most quickly and at the lowest cost. The cost of any given type of assistance would depend on FNMA's financial situation and, in some instances, the size of its portfolio and outstanding debt. There are numerous forms federal assistance could take, as demonstrated by those considered in the past to assist such entities as Lockheed Corporation, Chrysler Corporation, New York City, and Continental Illinois Corporation. Several forms of potential federal assistance are discussed below. The following examples are provided only as illustrations of the relative magnitude of risk to which the federal government may be exposed.

--Purchase of FNMA Debt. Section 304(c) of the FNMA Charter Act [12 U.S.C. 1719 (c)] authorizes the Secretary of Treasury to purchase up to $2.25 billion of FNMA debt obligations. (See chapter 5, p. 34 for discussion.) This action could be taken quickly and the federal government could earn a small interest margin profit if FNMA repaid the debt, because FNMA debt typically yields about 1/4 percent more than the Treasury's cost of borrowing.

--Statement of Federal Support. The federal government could issue a statement that it would provide whatever assistance necessary to prevent a FNMA bankruptcy. This could be done quickly and at no cost. Such a statement might prevent FNMA's borrowing costs from rising to a wider margin above the U.S. Treasury's borrowing rate as happened in 1981 and 1982.

--Guarantee of FNMA Debt. The federal government could guarantee FNMA's debt, thus making explicit what the financial community now perceives to be implicit. This step would take longer than the previous two as it would require congressional approval. There would be no direct cost to the federal government, so long as FNMA remained solvent and the government did not have to honor the guarantee.

--Federal Subsidy. Most economic scenarios in which FNMA would need financial assistance assume FNMA would have a large negative interest margin for several years. The federal government could subsidize FNMA by this amount. This would require congressional approval and could be quite costly. As shown in figure 3.2, FNMA negative interest margin was $506 million in 1982 on a smaller portfolio. ($71.8 billion on December 31, 1982, versus $87.9 billion on December 31, 1984.) The amount of negative interest margin in some future year would depend on the size, maturity, and yield of FNMA's portfolio and debt issues and the level of interest rates.

--Federal Takeover and Liquidation. The least likely form of assistance the federal government could provide would be to take over FNMA, liquidate the portfolio, and use federal funds to pay off FNMA debt obligations. If FNMA's $87.9 billion dollar portfolio, which had an average yield of 10.93 percent at the end of 1984, had been liquidated by the federal government on April 4, 1985, (and assuming the sale would not depress the value of mortgages in general), the federal government would have lost about $7.7 billion.[5] That is, the federal government would have had to provide about $7.7 billion of its own funds in addition to the proceeds of the liquidation to pay off all holders of FNMA debt at par.

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[5]This calculation assumes the federal government would package FNMA's portfolio into MBSs that would be similar to GNMA MBSs. On April 4, 1985, GNMA MBSs with a 11.00 coupon sold for 91.2 percent of book value to provide a yield to maturity of 12.41 percent. The calculation assumes that FNMA's portfolio yield had risen to 11 percent on April 4, 1985, (up from 10.93 percent on December 31, 1984), that this yield is approximately equal to a 11.00 coupon on GNMA MBS, and that the securitized FNMA portfolio would also be worth 91.2 percent of book value.

CHAPTER 4

RECENT FNMA CHANGES AND ECONOMIC CONDITIONS HAVE INCREASED CREDIT RISK AND FORECLOSURE LOSSES

The Federal National Mortgage Association conventional foreclosure loss for 1984 was $87.3 million,[1] up from $38.4 million in 1983 and $1.6 million in 1982. Also foreclosures on loans purchased by FNMA have increased from 0.29 percent of average total portfolio value in 1980 to 0.99 percent in 1984. Three years following the 1974 recession, the foreclosure rate also stood at 0.99 percent. FNMA delinquency rates have consistently exceeded those of FHLMC and the average of those reported in a survey conducted by the Mortgage Bankers Association.

FNMA may have contributed to the increase in its foreclosure rate by the aggressive steps it took in 1981 and thereafter to increase its loan portfolio with loans bearing high rates of interest. These steps had the intended effect of adding to fee income and reducing FNMA's negative yield spread, i.e., the yield difference between the average interest rates earned on its portfolio and the average interest rate paid on its debt. The resulting increase in income helped offset losses caused by the difference between its borrowing costs and interest income on older lower-yielding loans in the pre-1981 portfolio. However, FNMA's exposure to foreclosure loss also probably increased due both to its changed purchasing practices and to economic conditions. Among economic conditions which may have contributed to increased foreclosure losses were the following:

--significant decline in the rate of house price inflation,

--high interest rates, and

--increased unemployment due to the recession of 1981-1982.

FNMA also made changes in its purchasing practices which may have contributed to its increased foreclosure losses. Specifically, FNMA

--no longer required appraisals by FNMA-approved appraisers;

--relied on lender controls rather than approving each loan individually;

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[1]FNMA reported 1984 losses from foreclosed conventional properties at $87.3 million. According to a FNMA official, this includes accrued interest income that was not received, taxes, insurance, fix-up costs, brokerage costs, concessionary financing, carrying costs, and the difference between the sale price and the unpaid principal balance when acquired or an estimate of this difference if the property is unsold during the year.

--purchased loans on properties overvalued because of "buy-downs" (loans in which the builder pays a portion of the borrower's interest costs) and/or poor appraisals;

--purchased some loans with graduated payments which increase during the few years after origination, regardless of the movement in interest rates; and

--changed underwriting standards to allow borrowers to acquire increased debt as a percent of income.

In our opinion, these factors contributed to increased FNMA foreclosure losses. We did not, however, have access to data on individual foreclosures, nor to FNMA's analysis of its foreclosure experience. We, therefore, were forced to rely on the comments of knowledgeable industry experts and FNMA officials and on summary statistics to reach tentative judgments about the likely causes of the growth in foreclosure losses. The extent to which any single factor was responsible for foreclosure losses could not, therefore, be estimated. FNMA officials told us that FNMA has studied its foreclosure problem internally and has taken steps to reduce its losses in the future, such as instructing its loan originators to take greater precautions on screening applications, requiring lenders to repurchase loans not meeting underwriting standards, intensifying their post-purchase review, and tightening underwriting standards.

The management of FNMA changed in 1981 and with it came a change in strategies to solve the primary cause of its losses--the negative spread between the average net yield on its mortgage portfolio and the average cost of outstanding debt. In 1981, the average yield for the year on its portfolio was 9.45 percent, and the average cost of its debt was 10.81 percent, for a negative spread of 1.36 percent. In an effort to reduce this spread and reduce interest rate risk, FNMA's new management team, among other things,

--established the Special Deals Desk for acquiring mortgages and greatly expanding the types of mortgage instruments purchased, resulting in purchases of high-yielding mortgages in record volumes and

--purchased substantial volumes of adjustable rate and second mortgages, which allowed FNMA to more closely match the maturity of its assets with that of its borrowings.

NEGOTIATED PURCHASES

Management's efforts to increase the size of FNMA's portfolio by purchasing higher earning assets helped reduce the negative spread on portfolio assets to 1.30 percent in 1982 and 0.45 percent in 1983. In 1984 the negative spread increased to 0.57

percent. Most of these new purchases were acquired by FNMA through "negotiated transactions," by its Special Deals Desk. The Special Deals Desk was a program established by FNMA in mid-1981 to assist in acquiring loans that did not conform to its standard programs.[2] A FNMA official told us that the Special Deals Desk allowed lenders to negotiate terms and conditions on a particular loan package with FNMA after which FNMA would provide a purchase commitment. He said that this practice allowed it to purchase more loans because few standard conventional, fixed-rate, 30-year loans were being written at the high interest rates prevalent in the early 1980's. He said that these negotiated transactions also allowed lenders to write loans that would be attractive to consumers in their market area. In 1981 the Special Deals Desk made 16 percent of loan purchase commitments. This grew to 62 percent in 1982, 58 percent in 1983, and according to a FNMA official 52 percent in 1984. A FNMA official told us that during this period FNMA approved for purchase and acquired 128 different types of loans. He said that between 1981 and 1983 these included mostly payment-capped ARMS, growing equity mortgages (GEMs), graduated payment fixed-rate loans, and--buy-down loans. He added that in 1984 most loans purchased through the Desk were rate-capped ARMs, 15-year fixed-rate, and GEMs.[3] This was a significant change from its historical portfolio that contained nothing but FHA/VA and conventional fixed-rate and multi-family loans. FNMA stated in the first half of 1984 foreclosure losses resulted mainly from fixed-rate loans purchased in the 1981/1982 period of which some were buy-down loans.

Table 4.1 shows FNMA's portfolio. In 1981 FNMA began purchasing second mortgages and ARMs; by 1984 these instruments comprised about 16 percent of FNMA's total portfolio and reduced interest rate risk. FNMA, however, acquired relatively few FHA/VA loans after 1981. According to a FNMA official the reason was that these loans were assumable, and this feature caused FNMA to lower the price it would pay for FHA/VA loans to reflect the fact that they pose greater interest rate risk because they are less likely to be paid off. A FNMA official said it thus acquired

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[2]The standard loans included FHA/VA loans, fixed-rate conventional loans, and eight different adjustable rate loan programs.

[3]According to a FNMA official, temporary buydowns and graduated payment mortgages are inherently more risky than fixed-rate loans because buyers are qualified based upon mortgage payments, taxes, and insurance in the first year of the loan. As payments increase, the payment burden on the buyer increases and so does the probability of default.

fewer of these loans because GNMA prices were more competitive. FHA/VA acquisitions totaled $189.7 million in 1984 (net FHA/VA portfolio actually declined by about $2 billion). A FNMA official attributed the decline to amortization and early repayments, as compared to FNMA's acquisitions of $9.5 billion in conventional and $5.4 billion in ARM loans.

Table 4.1

FNMA Mortgage Portfolio
(millions of dollars)

End of period	FHA/VA	Conventional	Second mortgage	ARM	Multi-family	Total portfolio	Net[a] yield
1979	29,382	16,112	-	-	5,603	51,097	8.75%
1980	33,417	18,359	-	-	5,551	57,327	9.24
1981	34,551	21,159	175	102	5,425	61,412	9.85
1982	33,742	27,794	1,636	3,332	5,310	71,814	10.73
1983	30,999	32,537	2,385	7,126	5,208	78,256	10.70
1984	29,016	38,711	2,781	11,666	5,766	87,940	10.93

[a]Portfolio yield on December 31 of given year, yearly averages differ slightly, e.g., 1984 average portfolio yield equaled 10.81 percent.

Source: FNMA's fourth quarter 1984 "Memorandum to Investors and Financial Analysts."

FNMA FORECLOSURE LOSSES ROSE IN 1983 AND 1984

FNMA reported its largest annual net foreclosure loss on conventional loans of $87.3 million in 1984, up from $38.4 million in 1983 and $1.6 million in 1982. Foreclosure losses in 1984 reflect an increase in both the foreclosure rate and loss per foreclosure. These losses occur after receipt of $597 million from FHA/VA and private mortgage insurance (MI) companies for claims on foreclosed properties. FHA/VA loans are insured against virtually all loss by the federal government, while MI companies insure the holders of many other loans against loss. According to a FNMA official, MI typically covers the top 25 percent of the loan amount. FNMA's Charter Act requires all loans with loan-to-value ratios over 80 percent to have either mortgage insurance, seller's participation, or a repurchase option if the loan is foreclosed. According to a FNMA official, if an insured mortgage loan is foreclosed, the MI company has the option of (1) paying the coverage or (2) acquiring the property and paying the loan holder for the unpaid principal balance, accrued interest, and foreclosure expenses. In the 1970's, according to FNMA, MI companies typically acquired the

properties for resale because they would make money by reselling the properties because of continually rising house prices. In the 1980's, according to a FNMA official, the MI companies' standard practice is to pay the coverage for all lenders (including FNMA) and let the lenders (including FNMA) keep the properties, because they cannot be sold at a profit.

FNMA's reported foreclosure losses will appear lower in the future due to accounting changes FNMA made in 1984. Effective October 1, 1984, FNMA changed its accounting procedures for foreclosure losses. We estimate that this accounting change will reduce FNMA's reported foreclosure losses in 1985 by about $27 million from what FNMA would report using its previous accounting procedure. In the past FNMA accrued interest income for the entire period between delinquency and final foreclosure. FNMA's accounting change now limits the accrual of interest income to the first 90 days, similar to the practice employed by savings and loan associations. One FNMA official estimated the average foreclosure period at 12 to 14 months although the period generally ranges from a few months to 2 years depending in large part on state laws. The time required to foreclose on and sell a property affects FNMA losses because of the interest income lost and the costs associated with deterioration and vandalism while the property is held in inventory. The accounting change will reduce "interest income" on the income statement and reduce "loss from foreclosures" by a like amount.

To evaluate FNMA's foreclosure situation, we compared FNMA's delinquency and foreclosure rates with those of FHLMC and industry data provided by the Mortgage Bankers Association. We also compared FNMA's foreclosure rates to foreclosure rates provided by the Federal Home Loan Bank Board for FSLIC-insured institutions and FHLMC.[4] Comparison of these data is one measure of the quality of FNMA's portfolio. Table 4.2 shows FNMA's conventional loan delinquencies and properties-in-foreclosure as a percent of its conventional loan portfolio. This combined rate equals 6.54 percent and compares to industry average data compiled by the Mortgage Bankers Association, of 4.58 percent and FHLMC data of 2.69 percent. Table 4.3 shows FNMA's rate of conventional loan foreclosures increased from 0.08 percent in 1980 to 0.55 percent in 1983 and to 0.86 percent in 1984. Federal Home Loan Bank Board (FHLBB) foreclosures were 0.12 percent of its conventional loan portfolio in 1980 but increased to 0.41 percent in 1983 and 0.52 in 1984. FHLMC data show conventional loan foreclosures increased from 0.06 percent in 1980 to 0.14 percent in 1984.

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[4]The "in-foreclosure" and "foreclosure" data differ because not all properties that enter into the foreclosure process (i.e. "in-foreclosure") end up being foreclosed (i.e. "a foreclosure") because the borrower may make up the overdue payments or sell the property and pay off the loan.

Table 4.2

Total Conventional Loan Delinquencies[a] and Properties "in foreclosure" at Year End, 1979-1984

Year	FNMA		MBA		FHLMC	
	Delinquencies and "in foreclosure"	"In foreclosure"	Delinquencies and "in foreclosure"	"In foreclosure"	Delinquencies and "in foreclosure"	"In foreclosure"
	(percent)		(percent)		(percent)	
1979	3.98	0.26	2.94	0.10	N A	N A
1980	4.08	0.51	3.33	0.17	3.49	0.20
1981	4.43	0.61	3.59	0.24	3.76	0.31
1982	5.32	0.59	4.24	0.39	2.94	0.27
1983	6.13	0.85	4.29	0.46	2.69	0.26
1984	6.54	0.85	4.58	0.47	2.69	0.23

[a]Rates for FNMA and FHLMC represent all conventional loan delinquencies (including those "in-foreclosure" and under relief provision) as a percent of conventional loans. According to an MBA official, loans under relief provisions may or may not be included in MBA data depending on the practice of each reporting company. Rates are delinquencies plus properties-in-foreclosure and relief provision for FNMA and FHLMC. The degree to which relief provision is involved in MBA data is unknown.

FNMA Federal National Mortgage Association data, representing about 540,000 conventional single-family whole loans in 1984 portfolio.

MBA Mortgage Bankers Association data--based on a voluntary and anonymous survey of between 430 and 580 mortgage bankers, commercial banks, savings banks, savings and loan associations, and life insurance companies originating about 9.1 million loans on 1-4 units in 1984. (A FNMA official believes the survey is not accurate because it is voluntary; MBA disagrees.)

FHLMC Federal Home Loan Mortgage Corporation data, representing about 2.1 million single family fixed-rate conventional loans in 1984. FHLMC has comparatively few ARMs or multifamily loans. Over 95 percent are securitized and sold to investors; less than 5 percent are held in portfolio.

Table 4.3
Total Conventional Loan Foreclosures During the Year[a]
(as a percent of conventional loan portfolio)

Year	FNMA	FHLBB	FHLMC
1977	0.14	0.11	NA
1978	0.11	0.09	NA
1979	0.06	0.09	0.04
1980	0.08	0.12	0.06
1981	0.13	0.18	0.10
1982	0.24	0.33	0.15
1983	0.55	0.41	0.15
1984	0.86	0.52	0.14

[a]Mortgage Bankers Association does not keep foreclosure data.

A FNMA official said they owned about 5,400 properties at the end of 1984 with a market value of $247 million.[5] This compares to the 1983 total of 2,322 properties with a market value of $114 million. According to a FNMA official, it foreclosed 4,664 conventional, whole-loan properties during 1984. FNMA data also show that the value of its acquired properties plus foreclosure claims increased from $79 million in 1981 to $582 million in 1984.

[5]FNMA would not allow us to select and visit FNMA-owned properties.

Table 4.4
FNMA Conventional Foreclosure Loss Data
(thousands of dollars, cols. 2,3, and 6)

Year	FNMA conventional Single-family foreclosure losses[a]	FHA/VA & private insurance collected	Number of conventional whole loan foreclosures	Foreclosures as a percent of average total portfolio	Value of FNMA properties and foreclosure claims[b]
1977	330	347,554	275	0.99	93,477
1978	382	250,933	323	0.59	81,064
1979	795	203,182	219	0.37	61,537
1980	912	176,077	368	0.29	52,391
1981	812	230,684	606	0.42	79,288
1982	1,601	289,063	1,270	0.54	173,061
1983	38,386	425,440	2,963	0.72	357,035
1984	87,321	596,749	4,664	0.99	582,418

[a]Excludes losses of $7,000 on mortgage backed securities in 1983 and $1,612,000 loss on same in 1984.

[b]According to a FNMA official, the value of properties equals the unpaid principal balance at time of acquisition, plus interest accrued during foreclosure process, plus taxes, insurance, legal fees, and repair costs. The value of FNMA properties will be smaller in 1985 than it would other wise be because of an accounting change effective October 1, 1984, (see discussion page 42).

Source: FNMA's "Guide to Debt Securities," November 20, 1984, and "Memoranda to Investors and Financial Analysts," 1977-1984.

In November 1984 FNMA's Senior Vice President for Mortgage Operations was reported in the November 1984 issue of Real Estate Finance Today as indicating FNMA was in the position of trying to sell more than 5,000 properties it has acquired through foreclosure. Further, this was a far cry from just 2 years ago when the number of REOs (real estate owned) on FNMA's books was hardly worth mentioning. He said "It used to be so few that we never really kept count. It was about 100." The article further states that the increased number of REOs is resulting in quite a monetary drain for FNMA. The FNMA senior vice president was also quoted as saying "The cost of just carrying these properties averages out to $5,000 per unit."

FNMA ACTIONS TAKEN IN RESPONSE TO FORECLOSURE LOSSES

FNMA has analyzed many of its foreclosed loans, issued guidance, and changed procedures to lessen future loan losses. A FNMA official hold us in response to FNMA's foreclosure losses, it analyzed about 2,500 foreclosures[6] completed in the first 6 months of 1984. According to an article in the October 1984 Real Estate Finance Today, FNMA's losses on these loans averaged $15,000 each, after receiving mortgage insurance payments. According to a FNMA official, about 75 percent were fixed rate and about 25 percent consisted of ARMs, mostly graduated payment ARMs (GPARMS). FNMA found that the preponderance of foreclosed loans were conventional fixed-rate mortgages made during the 1981-1982 recession. A majority of these foreclosures was in California (24 percent), Texas (18 percent), Michigan (10 percent), and Washington (6 percent).

In September 1984 FNMA announced it was increasing its $58.7 million for loan losses on conventional mortgages by $35 million. FNMA's Chief Executive Officer said that this $35 million addition contributed about $18.2 million of FNMA's $43.1 million after-tax loss in third quarter 1984. On October 1, 1984, FNMA also increased its contribution to the loan loss reserve for each conventional mortgage purchased from 0.25 percent to 0.60 percent of the unpaid principal balance. A FNMA official told us that this change increased the fourth quarter 1984 contribution to the reserve from $5.5 million to about $15.4 million. Several industry officials told us that an industrywide increase in foreclosure losses has prompted the private mortgage insurance companies to raise their premiums.

On November 5, 1984, according to an article in the November 1984 issue of Real Estate Finance Today, FNMA's President stated, in response to foreclosure losses, also sent a letter to lenders that told them, in effect, to tighten up their loan standards. The letter, as reported, stated that since FNMA implemented streamlined procedures for selling and servicing in 1981, it had relied on the judgment of lenders to ensure that the loans purchased were of investment quality. Further, the letter noted that the success of FNMA's system depends on the willingness and ability of its approved lenders to employ servicing procedures to minimize the risks of default. However, the letter stated

> ". . . some do not have, or are not effectively utilizing, an adequate quality control system to

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[6]A FNMA official said this sample was not representative of the universe of bad loans, but it would not provide the study or data on individual foreclosures to us.

ensure that all loans originated meet the lender's standards and those of its insurers and investors."

The article further noted that to reduce future losses due to foreclosures, FNMA has a post-purchase review system to help identify significant deviations from FNMA's published underwriting standards. When the review discloses loans that do not meet the standards and requirements, FNMA will require lenders to repurchase the loans or substitute loans that do meet FNMA standards. The letter concluded that FNMA remains committed to the streamlined business approach adopted in 1981 and has no intention of returning to the more costly approach of requiring prior approval of lender underwriting and servicing decisions.

According to a FNMA official, FNMA has a long-established quality control system that is designed to monitor portfolio performance, review FNMA lenders, and analyze problem areas.

FNMA's quality control program has four elements:

1. Lender approval--FNMA approves lenders based on a review of the lender's organization, staffing, origination and servicing volumes, performance, and financial condition.

2. Monitoring of lender operations--FNMA reviews lender operations on a periodic basis by examining the mortgages delivered by the lender, delinquencies, foreclosures, acquired property, cash remittance patterns, and reporting performance.

3. Mortgage review procedures--FNMA monitors new mortgage investments by performing an in-depth review on a random sample of loans and on other loans on a discretionary basis.

4. Audit function--FNMA has an internal audit function that is responsible for developing and implementing a broad comprehensive audit program covering all phases of FNMA's operations.

According to FNMA officials, FNMA increased the emphasis in a couple areas of quality control as a result of its record foreclosure losses. These include examining every loan that is foreclosed and increasing the number of lending institutions examined.

A FNMA official believes foreclosure losses may have peaked although he is uncertain about whether the number of foreclosures has peaked. He pointed to reduced foreclosure losses in the third and fourth quarters of 1984 and said that the problem loans purchased in the 1981/1982 recession and those with deep buy-downs are behind them and that losses per foreclosure should be

less in the future. However, a vice president for Salomon Brothers[7] noted that FNMA's large loss reserve may be a sign of loan-quality problems ahead.

Beginning in 1982 FNMA purchased substantial numbers of ARMs to reduce its interest rate risk. An article in the November 19, 1984, issue of Business Week (p. 146) said:

> "The rub is that Fannie Mae may be trading away some of its interest rate risk and getting credit risk in return. General Electric Mortgage Insurance Company has found that losses on loans carrying some aspect of payment variability are twice as great as those on traditional fixed-payment loans."

According to the president of one mortgage insurance company,

> ". . . This trend is significant because our loss experience with the traditional mortgage instrument has doubled in the '80s, so these non-fixed-payment mortgage studies point to a loss level which is four times greater than our industry has historically experienced."

CAUSES OF FNMA LOSSES

The Chairman of FNMA, as reported in a news release, said the corporation's increase in foreclosure losses are related mostly to a large volume of conventional 30-year, fixed-rate mortgages purchased during the 1981-1982 recession. This was a period of high unemployment, slowed growth in wages, and deceleration in the rate of appreciation of housing prices. FNMA's Senior Vice President for Mortgage Operations cited several factors that contributed to the high rate of foreclosures. These included increased unemployment and the impact of a poor economy. Another factor affecting foreclosures was inadequate owners' equity, resulting from loans made with little or no down payment, loans structured to include negative amortization, and depreciation in the value of the property in some markets.

Senior FNMA officials would not provide information about individual foreclosures. Therefore, we relied on aggregate data available from FNMA and information provided by industry sources. We interviewed senior officials from several financial institutions about their foreclosure experience to better assess the

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[7]Salomon Brothers is a major financial company that brokers FNMA debt securities and, according to a FNMA official, is a competitor of FNMA in the secondary mortgage market.

foreclosure loss issue in the market place. We interviewed officials from the Mortgage Bankers Association, U.S. League Savings Institutions, FHLMC, private mortgage insurance companies, several large financial companies dealing in home loans, and an organization that deals directly with FNMA-foreclosed properties. These officials suggested various causes for FNMA's foreclosure problem. A discussion of these causes follows.

Economic factors: Throughout most of the 1970's, the U.S. economy experienced strong inflationary pressures. During this period housing was financed by a financial system originally established in the 1930's. This system provided long-term fixed-rate mortgages to homebuyers at relatively low real (after adjustment for inflation) interest rates. This financial arrangement led housing to be viewed as a good investment and an inflationary hedge, since home values rose faster than inflation.

However, the real interest rate increases in the early 1980's and the deregulation of the financial markets forced changes in the environment in which housing was bought and sold. These changes have caused the real cost of purchasing a home to increase substantially. High nominal and real interest rates, declining rates of house price appreciation, and changes in consumer tastes have increased the level of risk in mortgage lending.

Changes in FNMA's business practices: In mid-1981, FNMA began aggressive purchases of high-yielding mortgages to increase its return on portfolio and broadened its customer base by purchases through the Special Deals Desk. This change assisted FNMA in increasing the size and yield of its portfolio through purchase of 128 different types of loans during a period of high interest rates. Also in 1981, according to a FNMA official, FNMA streamlined procedures for selling and servicing loans, by discontinuing prior approval of loans, and relied on the judgment of approved lenders to ensure that the loans sold to FNMA met FNMA underwriting standards. This FNMA official told us that FNMA also discontinued the requirement that lenders use FNMA-approved appraisers. However, according to several industry officials, FNMA's actions to solve its portfolio problem (interest rate spread) may have contributed to FNMA's portfolio containing some high-risk loans. Several industry officials also suggested that many of FNMA's foreclosed loans may have been originated by loan brokers, loan brokers originate loans only for resale and do not have portfolios of their own.

Were ARMs a problem?: FNMA has significantly increased its purchase of ARMs in recent years that may involve somewhat higher credit risk than fixed-rate loans. To examine this potential

impact, we employed a financial consultant[8] to examine the possible role ARMs may have played in FNMA's losses and the impact ARMs might have on future profitability. The results of this work indicate that:

1. ARMs probably had little impact on FNMA's foreclosure losses to date in part because most ARMs originated during the last few years were longer-term instruments, and they have not yet reached their adjustment period. They could not, therefore, be responsible for precipitating defaults through "payment shock." Furthermore with decreasing interest rates those which have adjusted have adjusted primarily to lower rates. Negative amortization among these primarily payment-capped instruments has been minimal thus far.

2. However, in a steeply rising interest rate environment, these same ARMs would result in increased defaults as compared to the fixed-rate instruments. The interest-rate-capped ARMs that currently dominate FNMA purchases are expected to be less of a problem. Than some of the payment capped instruments. Shorter-term instruments, those with the graduated payment option, and those with the maximum permitted first-year discounts performed most poorly in such an environment.

3. FNMA has reduced its interest rate risk but increased its default risk by moving to ARMs. However, the increased yield flexibility of the ARM designs in use today, should result, in most circumstances, in increased yields that will more than offset the losses caused by increased default risk.

Low owner equity: Industry officials often mentioned owner equity as a significant factor in foreclosures. FNMA is more prone to this condition than most institutions because it approves and purchases loans with higher-than-average loan-to-value (LTV) ratios, such as 95-percent loans. Between 1972 and 1983 its average LTV ratio on portfolio purchases has exceeded the national average by 5 to 15 percentage points, this difference averaging about 10 percentage points. (According to a FNMA official, data for 1984 were not available as of March 1985.)

In recent years several factors other than LTV ratios have also had a direct impact on owner equity. These include negative amortizing loans, inflated appraisals, and home-price deflation.

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[8]Kerry D. Vandell, Associate Professor, Southern Methodist University.

The adjustable rate mortgage became popular in the early 1980's with record high interest rates; however, some of these loans negatively amortize the loan principal in the first few years. Homeowners with negatively amortizing loans owe more on their homes after the first few years than at the time of purchase. This can be a significant problem in connection with home-price deflation. Private mortgage insurance officials of one company said appraisers are supposed to be a check on the mortgage system by providing accurate appraisals, but they are not. These officials said many appraisers are not licensed, approved, or tested. An industry official said appraisers are under pressure by the seller and lending institution to come up with an appraisal that equals or exceeds the agreed-on purchase price. An official of one private mortgage insurance company said "appraisal shops" existed that would give any appraisal wanted for a fee.

In 1980 persistent house-price inflation slowed and in some places house prices declined. Industry officials said appraisers and people who purchased their homes in the 1979-1980 period were accustomed to persistent high inflation. If an appraisal was a little high, it would be covered by the next year's price escalation. However, in 1980 when in some areas home-prices began declining, some new homeowners found that their property was worth less after a year or two. In some cases they owed more on it than it was worth. We were told this was a frequent problem in Southern California, and that many people walked away from the property, resulting in a loss to the loan holder and mortgage insurance company.

Industry officials told us that yet another factor affecting owner equity was "builder buy-down" loans. These loans consisted of reduced downpayments or interest rate reductions subsidized by the builder and designed to attract buyers. However, builders would sometimes increase the price of the property to reflect the buy-down, and when appraisers did not recognize that the price overstated the property's true value, people purchased overpriced units. When they purchased these units for little or nothing down, in a year or two they found their property worth less than the mortgage balance. FNMA bought some of these builder buy-down loans.

A special kind of low/no-equity loan was among FNMA purchase according to a FNMA official. He said this type of loan allowed the builder to put up the downpayment (5 percent of selling price) and place it in escrow. The buyer purchased the unit for no downpayment. As the buyer's equity through payment of principal attained 5 percent, the builder would get his escrowed 5 percent back. FNMA had also required the lender to pay a nonrefundable fee, equal to 2.5 percent of the loan amount, to FNMA which was put in its reserve for losses and the lender had to agree to repurchase the loan if it went bad. The problem, according to a FNMA official, is that they found the builder would merely raise the price of the property by 5 percent to cover the downpayment.

On February 1, 1984, the President, Mortgage Insurance Companies of America, testified before a congressional hearing[9] concerning the soundness of the mortgage contract offered to home buyers. He said

> "The key point is that lenders and insurers operating in free markets must have the self-discipline to restrain themselves regarding risk if they are to have long-term success in the secondary market.
>
> The most important trend in 1984 will be a return to emphasis on the 'quality of credit.' Foreclosures remain high, and the deregulated mortgage forms introduce significant new risks to the market. Some of these new instruments are yet untested for risk, especially builder buydowns and certain of the adjustable payment instruments. 'Payment shock' is a term which may be heard increasingly in the future as monthly principal and interest charges rise. It refers to the inability of a home buyer to absorb within 1 year the increases in mortgage payments in excess of probable increases in monthly income."

The testimony provides several examples of buy-downs and expresses concern over ability to pay, value of the property, and risk to the industry.

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[9]Subcommittee on Housing and Community Development, House Committee on Banking, Finance, and Urban Affairs.

CHAPTER 5

FNMA's FINANCIAL ADVANTAGES AND THE BENEFITS IT PROVIDES HAVE CHANGED OVER TIME

FNMA's business activities are shaped to a large extent by its extensive federal government ties. In 1968, when it was transformed to a privately owned corporation, FNMA was provided a number of federal privileges as well as certain restrictions on its business activities. However, since then FNMA's secondary market role, the benefits it provides, the restrictions it is subject to, and its costs to society and government have undergone significant change.

FNMA has played a significant role in assisting the nation's housing and mortgage markets; but over time, the importance of some of FNMA's original public policy roles has diminished while FNMA has responded to new market demands.

--FNMA played a significant role in building the secondary market, along with other federal credit agencies. But the market is now much more broadly based and it is no longer dependent upon a single actor.

--FNMA's role in helping provide housing to low- and moderate-income households has declined as it shifted from purchasing FHA single-family mortgages to conventional mortgages and the government-reduced subsidies for FHA multifamily housing programs. Furthermore the definition of low- and moderate-income benefits in HUD regulations is out of date and no longer requires any particular emphasis because it is based upon unrealistic assumptions about buyer incomes relative to home purchase prices.

--FNMA's countercyclical role in moderating housing credit cycles, which was significant in the 1960's and 1970's, is no longer clearly demonstrable. Deregulation (particularly easing of thrift institution interest rate limits), other significant changes in the banking and thrift industries, and the growth of the secondary mortgage markets have altered the nature of credit cycles.

--FNMA's adaptation to the changing mortgage market has resulted in a significant shift in its role. For example, its issuance of mortgage-backed securities, along with FHLMC, has helped many thrifts restructure their portfolios using mortgage swaps (see chapter 2). And, according to FNMA, its role has shifted to reducing the cost of mortgage credit, providing innovation, assuring funding for new mortgage instruments, improving buyer affordability through adjustable rate mortgages, and improving pricing efficiency and liquidity for new products, such as conventional multifamily loans and second mortgages.

To permit FNMA to accomplish its public purposes, Congress conferred it with certain privileges not available to most private corporations, but also limited it to one line of business --the residential secondary mortgage market. Within this industry, FNMA is further limited in the type of loans it can purchase and remains subject to federal oversight and regulation.

However, like other federal credit agencies and thrift institutions, FNMA's charter-imposed responsibilities and restrictions are accompanied by important privileges. The most important advantage FNMA derives from its government connections is the perception in the credit markets that FNMA has federal agency status. "Agency status" provides wide acceptance for its securities and lowers its cost of raising funds. Without this perceived status FNMA would not have grown to its present size as a portfolio lender and would have gone out of business in recent years. Other advantages include exemption from SEC registration fees, which saved FNMA an estimated $5 million in 1984, and exemption from state and local income taxes, which we estimate saves FNMA roughly 4 to 9 percent of its before-tax income. In a profitable year such as 1983, the tax exemption was worth $5.5 million to $12.4 million to the corporation.

Over time the aggregate dollar value of these benefits to FNMA has grown because, to a large extent, the benefits are related to the size of FNMA's portfolio and its borrowing. As its portfolio grows, the value of its borrowing advantage increases.

The costs of providing FNMA these financial advantages are borne by state and local governments, other borrowers who may pay somewhat higher interest rates because of FNMA's preferred place in the credit markets, and the federal government. The federal government incurs no direct expenditures for FNMA other than those associated with regulation and oversight, but the perception of the government as FNMA's guarantor and the likelihood that the government would extend assistance in the event of a severe financial crisis constitute a perceived contingent liability.

An overview of the interrelationships between FNMA's advantages and restrictions and the benefits it has provided is provided in figure 5.1

Figure 5.1

FNMA, the Government, and Society:
Benefits, Costs, and Restrictions

SOCIETY HAS BENEFITED FROM FNMA ACTIVITIES THROUGH...

- Increased supply and lowered cost of mortgage credit by tapping non-traditional sources of capital.
- Countercyclical mortgage purchases.
- Development of a secondary mortgage market.
- Innovations and standard setting in mortgage documents and practices (e.g. ARMs, MBS swaps, seconds)
- Contributions to the goal of providing adequate housing to low- and moderate-income families.

FNMA DERIVES ADVANTAGES THROUGH ITS FEDERAL CONNECTION FROM...

- Perceived increased creditworthiness, which lowers borrowing costs and increases access to the credit markets.
- "Backstop" borrowing at Treasury's discretion and possible government assistance in a financial crisis.
- Exemption from SEC registration fees.
- Federal designation of FNMA obligations as acceptable investments for certain regulated institutions (e.g., banks and pension plans).
- Exemption from state and local income taxes.

BUT FNMA ACTIVITIES ARE NOT COSTLESS BECAUSE...

- Capital funneled into the mortgage market is not available for other purposes.
- Investors would risk loss if FNMA experiences financial difficulty.
- Potential costs of federal financial assistance to FNMA.

AND THE FEDERAL CONNECTION COSTS FNMA IN TERMS OF...

- Limitations on allowable business activities.
- HUD oversight and regulation.
- Treasury concurrence needed for entry into the credit market.

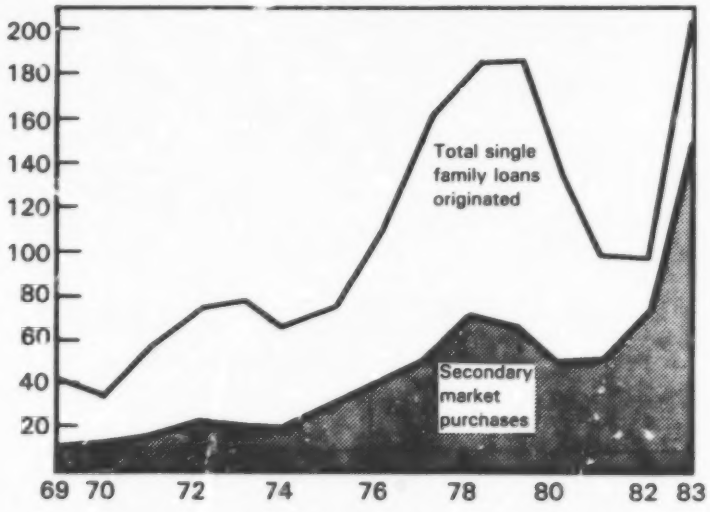
BENEFITS TO THE HOUSING AND MORTGAGE MARKETS FROM FNMA's ACTIVITIES

FNMA's contributions to the housing and mortgage markets have been important, but changing conditions have either changed the nature of its present role or reduced the magnitude of certain of the significant benefits FNMA has provided.

Growth of the secondary mortgage market

FNMA, along with other federal credit agencies, was an important actor in transforming the secondary mortgage market into the dominant source of mortgage funds in the United States. Mortgage bankers had long been active in packaging mortgages for sale to institutional investors. But the overall size of the secondary market and its ability to reach out to a broader range of investors depended heavily on the standardization and reduction in risk provided by government involvement. As indicated in Figure 5.2, the secondary market grew from $11.5 billion in 1969 to $148 billion in 1983.

Figure 5.2
Growing Importance of the Secondary Mortgage Market
Comparison of Secondary Market Activity to Total Originations of 1-4 Family Mortgage Loans 1969-1983
$ (billions)



Sources: HUD, Third Annual Report on National Housing Goals, June 29, 1971 and FNMA, Historical Perspective on the Secondary Mortgage Market, December 1984.

Notes: Excludes FNMA and FHLMC "seasoned swaps" in 1981-1983.

The secondary market has also come to dominate single-family lending. In 1969 the secondary market purchases of eleven major mortgage lender groups represented 27 percent of the dollar value of all originated single-family mortgage loans.[1] By 1983 the secondary market absorbed 73 percent of all single-family loans, although this may have been an abnormally high share due to a large number of mortgage refinancings as interest rates came down. GNMA-backed FHA loans took a large share of these refinancings.

In the late 1960's and early 1970's, FNMA was the major actor in the secondary mortgage market. (See figure 5.3.) In 1969 and 1970 FNMA's mortgage purchases were equivalent to over a third of the dollar value of all mortgage purchases in the secondary market. Overall, government-related agencies have accounted for over half of all secondary market activity in most years since 1969. FNMA's share of the activity has moved up and down somewhat in response to housing cycles but has generally declined from its share of agency activity in the early 1970's.

Mortgages are not considered liquid investments. They are supported by the value of the real property underlying the mortgage. Traditionally, mortgage loans were originated, held in portfolio, and serviced by thrift institutions in local communities. The costs involved in certifying the property security underlying mortgages made it difficult to sell mortgages to other investors or to channel mortgage funds from capital rich regions of the country to regions where funds were needed.

FHA-insured and VA-guaranteed loans were the first mortgage instruments to gain acceptance in the secondary markets. Government backing and greater standardization stimulated acceptance of these securities among a broader range of investors. FNMA's purchase of these loans on a large scale meant that other investors could generally be assured of the liquidity of such mortgages. As the secondary market matured, mortgage-backed securities and extensions of activity to insured conventional loans broadened the size and scope of the secondary market.

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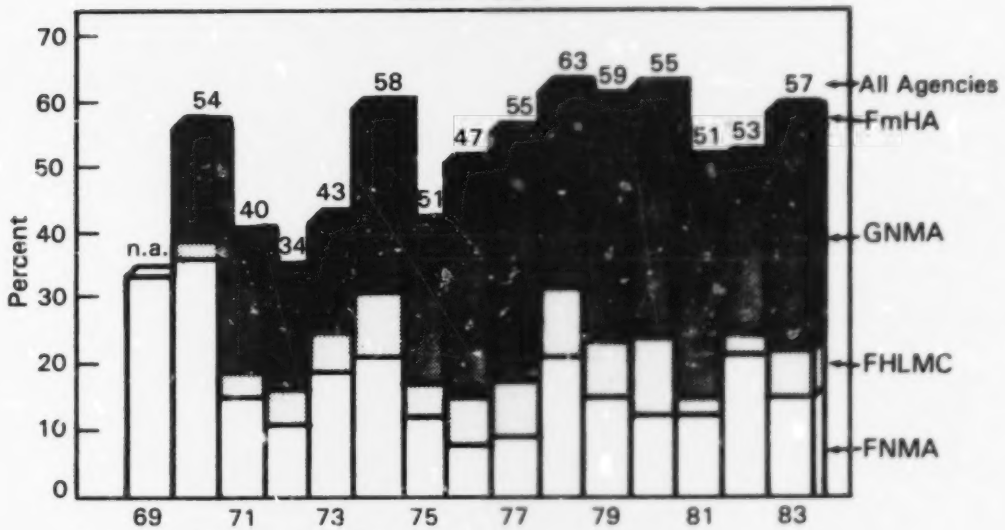
[1] In addition to federal credit agencies (e.g., FNMA, FHLMC, GNMA and FmHA), the lender groups include savings and loan associations, mutual savings banks, commercial banks, life insurance companies, mortgage companies, pension funds, credit unions, real estate investment trusts, and state and local pension funds.

Figure 5.3
Federal Sponsored Agencies and Federal Agencies Percentage of Secondary Market Activity
1969-1983



Note: Only FNMA Active in 1969

Source: HUD, Secondary Mortgage Market 1984-Mid Year Review

General benefits of the secondary markets

The major benefits of a strong and active secondary mortgage market include

--facilitating flows of funds for housing investments between regions,

--attracting capital for housing investment from a broader range of sources,

--allowing homebuyers to compete for funds in the credit markets like any other borrower, and

--reducing mortgage interest rates.

FNMA assists in providing these benefits along with other secondary market participants.

Innovation and standard setting

FNMA has also served as an industry innovator and a standard setter for mortgage documents and practices. Its size and recognition in the market place allowed it to help set standards. Standardization of mortgage instruments, documents, and accepted origination procedures contributed to investor confidence and hence the development of the secondary mortgage market. In some cases, FNMA led these efforts; in others, it worked in cooperation with other agencies like GNMA or FHLMC. Examples include[2]

--development of uniform, conventional mortgage documents;

--development of conventional mortgage underwriting standards;

--development of standards for condominium and Planned Unit Development Mortgages;

--development of ARM standards;

--introduction of optional and mandatory delivery standby commitments; and

--mortgage-backed security swaps.

Tapping alternate sources of credit and enhancing market efficiency

FNMA asserts that it raises capital that might not otherwise be invested in housing because it issues fixed-term short-, intermediate-, and long-term debt securities. These securities are attractive to certain investors that do not wish to invest directly in mortgages (or MBSs) because of default risk, lack of liquidity, or uncertain maturity. For example, individuals, state and local government funds, and bank-administered trusts purchased an average of 36 percent of FNMA's debentures and 55 percent of FNMA's notes over the years 1979-1983. According to FNMA, these investor groups do not actively participate directly in the mortgage market.

FNMA literature asserts that since FNMA acts as a market maker, and not just as a provider of liquidity for mortgages or a buyer of last resort, it improves the pricing efficiencies in the

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[2]For a more detailed discussion see FNMA, Serving the Nation's Homebuyers, Housing Industry, and Housing Finance System: The Benefits of Fannie Mae, December 1984.

secondary mortgage market. For example, it states that when FNMA began purchasing second mortgages in 1981, the primary market demanded a 3 percentage point spread over first mortgages. However, after purchasing more than $3.5 billion of second mortgages, FNMA in December 1984 was purchasing second mortgages that yielded less than one-half percentage point more than first mortgages. Evaluation of the degree to which FNMA promotes pricing efficiencies in the secondary market and several of the many other benefits FNMA asserts it provides is beyond the scope of the report. FNMA's description of these benefits is contained in a 51-page publication Serving the Nation's Homebuyers, Housing Industry, and Housing Finance System: The Benefits of Fannie Mae, dated December 1984.

FNMA's countercyclical role

Housing production and credit markets have typically been marked by strong cyclical patterns. The housing sector is particularly sensitive to fluctuating interest rates. As interest rates increase, home sale and housing production generally decline. In the 1960's and 1970's, FNMA's purchases of mortgages for its portfolio served to moderate the cyclical influence on the housing sector. However, financial deregulation and FNMA's diminished role in a growing secondary market raise the question of whether countercyclical activity by FNMA will be possible in the future.

Before 1979, cyclical swings in interest rates tended to have a pronounced impact on the availability of mortgage credit. In the earlier cycles, as general market interest rates rose, thrift institutions, the primary source of mortgage loans, were faced with sharp decreases in flows of new deposits because they were limited in what they could pay depositors. Depositors shifted funds from thrift institutions, which invested primarily in mortgages, to other financial intermediaries or investments, thus reducing funds available to housing. This flow of funds away from the primary market for mortgages exacerbated the dampening effects that rising interest rates and general economic conditions were having on home sales. FNMA's purchases of mortgages helped counter this behavior of primary market lenders. FNMA could continue supplying credit because it was able to reach a broader range of investors; and, more importantly, it did not face the same constraints on what it could pay for funds. FNMA stayed in the market and increased both mortgage commitments and purchases of mortgages for its portfolio in the 1969-1970 and 1973-1974 housing downturns.

Several studies of FNMA's countercyclical role before 1980 recognize this countercyclical influence.[3] As shown in figures 5.4 and 5.5 during the 1970's, FNMA purchases and commitments tended to move up as housing starts fell and disintermediation occured in the thrift industry. Some analysts, however, contend that FNMA's countercyclical role could have been even more pronounced.[4] For example, FNMA continued to buy mortgages even when housing and mortgage activity was relatively robust as in 1972-1973 or 1975-1976. According to these analysts, during periods of plentiful mortgage money, FNMA should have made net sales of mortgages if countercyclical activity was its principal objective. Such sales, however, would not necessarily be to the benefit of FNMA stockholders. This became an issue between FNMA and the HUD Secretary in 1978 but is less important than FNMA purchases at the low point in the cycle.

FNMA's countercyclical role has likely declined (or changed)

The late 1970's and early 1980's saw a revolution in the institutional structure underlying the mortgage market. These changes affected the nature and structure of both primary and secondary mortgage markets and will have a pronounced effect on the nature of FNMA's countercyclical activity. Before 1980 little activity existed to lessen the impact of rising interest rates and growth of money market funds on thrift institution saving flows except for some authority to issue money-market-based certificates of deposit. But beginning with the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) in 1980, the situation began to change rapidly. DIDMCA set up a schedule for removing deposit ceilings at thrift institutions. The Garn-St. Germain Depository Institutions Act (1982) authorized federally insured money market accounts with no interest ceiling that could compete with money market funds. Thrift institutions were also granted

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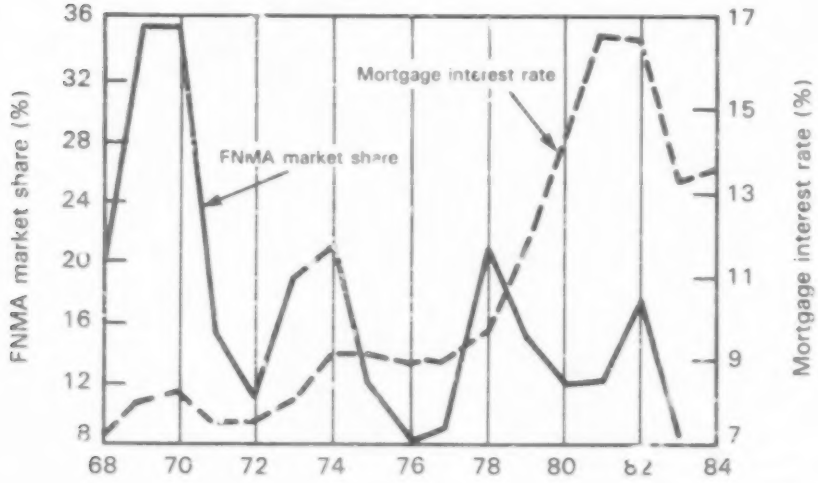
[3]D. M. Jaffee and K. T. Rosen, "Estimates of the Effectiveness of Stabilization Policies for the Mortgage and Housing Markets," The Journal of Finance, June 1978, pp. 921-932; William L. Silber, "A Model of Federal Home Loan Bank System and Federal National Mortgage Association Behavior," The Review of Economics and Statistics, August 1973, pp. 308-320; and C. Swan, "The Markets for Housing and Housing Services: A Comment," Journal of Money, Credit and Banking, November 1973.

[4]Leo Grebler, "An Assessment of the Performance of the Public Sector in the Residential Housing Market: 1955-1974"; Resources for Housing, Federal Home Loan Bank of San Francisco, Dec. 1975, pp. 349-79; and Herbert M. Kaufman, "FNMA and Its Relationship to the Mortgage Market," Journal of Bank Research, Autumn 1981, pp. 145-152.

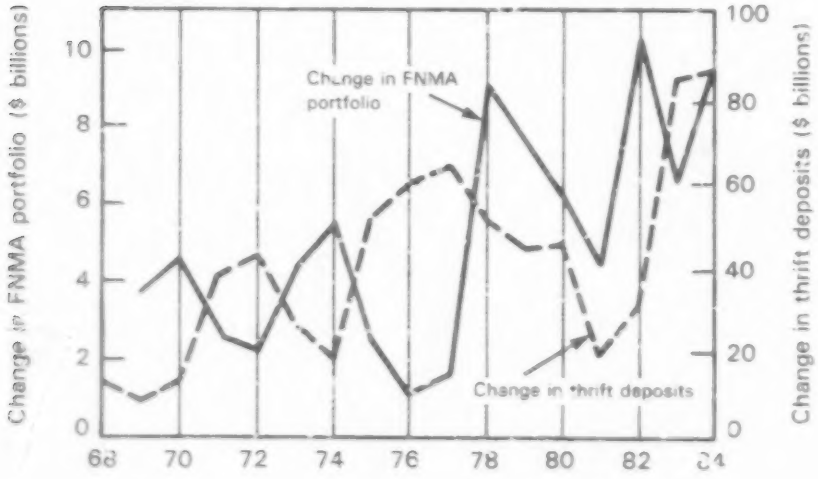
Figure 5.4
FNMA's Countercyclical Role

FNMA's market share has tended to increase as interest rates rise . . .



. . . but with the rapid increase in mortgage rates in 1979-1981, FNMA's market share fell and did not increase significantly until 1982.

FNMA's portfolio activity tended to offset declines in thrift deposits in the early 1970's . . .

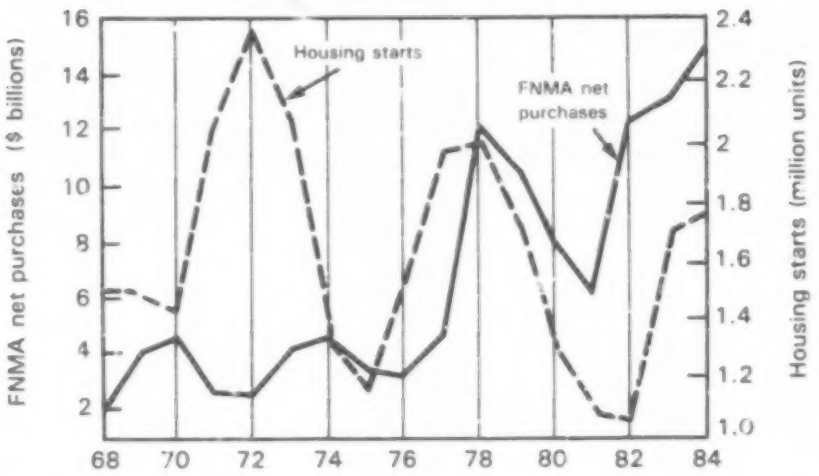


. . . but in the 1979-1984 period FNMA and thrift deposits generally moved in the same direction.

Source: FNMA and Data Resources, Inc.

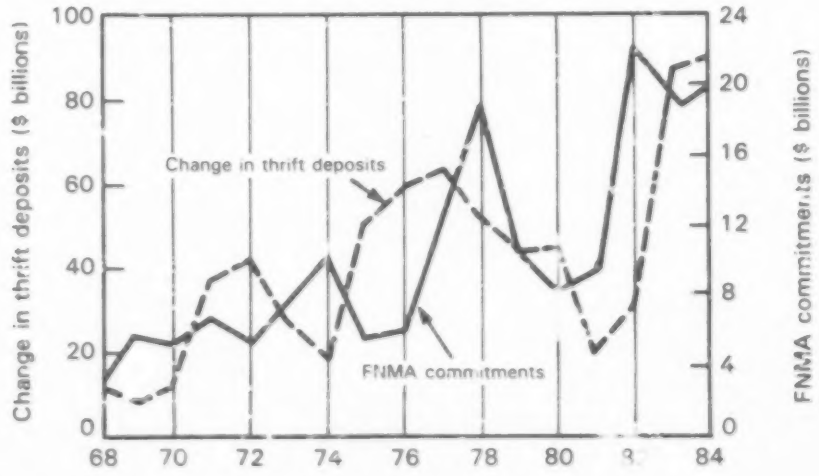
Figure 5.5
FNMA's Countercyclical Role . . . Continued . . .

FNMA has typically increased its mortgage purchases as housing production falls . . .



. . . but FNMA purchases moved down with housing starts beginning in 1979 and rebounded in the 3rd quarter of 1981 just before starts picked up in the 2nd quarter of 1982.

FNMA commitments to purchase mortgages have also tended to compensate for changes in thrift deposits . . .



. . . but since 1978 the pattern has been less consistent.

Source: FNMA and Data Resources, Inc.

authority to expand into a broader range of investments as well as introduce a greater variety of savings instruments. These changes, along with the greater volatility in interest rates associated with the 1979 Federal Reserve Board decision to focus on control of monetary aggregates rather than interest rates, led to a radically different home finance market in the 1980's. The secondary market also became a much more important component of the mortgage market during this period, in large part as a consequence of the trend toward mortgage-backed securities.

During the last housing cycle, deposits at thrift institutions still moved down as interest rates increased despite some of their new-found powers. However, this may have been a result of a lack of demand for mortgage money by consumers, causing thrifts to compete less aggressively for funds that they could not relend.

FNMA's activity did not clearly counter the housing cycle during this period. (See figures 5.4 and 5.5.) FNMA mortgage purchases slid from a high in 1978 to a low in 1981, despite growing mortgage interest rates and a steady decline in housing production. As thrift institution deposits declined in 1981, FNMA mortgage purchases also fell off. Toward the end of 1982 and especially in 1983, thrift institution savings flows increased rapidly, as did FNMA loan purchases for its portfolio.

FNMA contends, however, that 1981 was atypical because previous management elected not to increase its portfolio size in the first half of that year in response to its worsening financial situation. Current management reversed that decision in the second half of the year. In late 1981 FNMA notes that purchases did climb sharply, while thrift deposit growth moved up slowly and housing starts fell to a post-war low.

FNMA also points out that its share of the mortgage market increased dramatically in late 1981 and 1982 and declined to its lowest level in 1983 consistent with its countercyclical role.[5] But this 1983 decline in market share occurred despite the fact that FNMA portfolio purchases were at their highest historical level and may actually reflect the rapid overall growth of mortgage lending in 1983 and the less pivotal role FNMA now plays in the secondary market. Many experts believe that the growth of the secondary markets and the closer tie between mortgage lending and the credit markets meant that money was readily available to purchasers who were willing to pay for it.[6] Thus, FNMA and other lenders may merely have been following the lead of the consumer.

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[5]FNMA, The Benefits of Fannie Mae, p. 6.

[6]Analysis of Options for Aiding the Homebuilding and Forest Products Industries (GAO/RCED-82-121, Aug. 31, 1982).

The major changes that took place in financial markets have probably not been completely absorbed by the secondary mortgage markets. Some economists expect that housing credit cycles will be modified as a result of these changes but that the roles of the key actors are still being sorted out. Whether housing credit cycles in the future will be dampened[7] depends on the long run efficacy of the changes that have been made. The future nature of a countercyclical role for FNMA is therefore difficult to forecast. FNMA officials and representatives of other housing industry groups suggest that it will be necessary to experience at least one full business cycle after financial institutions have had time to adjust to these changes before a true judgment can be reached as to whether the housing credit cycle has been significantly dampened.

FNMA's comments on its countercyclical role

In its comments on a draft of this report FNMA highlighted its belief that its role has changed from increasing credit availability to one of lowering the cost of credit during cyclical downturns. They argued that in future credit crunches,

> ". . . deregulated thrifts will have to rely almost exclusively on uninsured high cost deposits to fund mortgage demand. Fannie Mae, on the other hand, can complement the thrifts by accessing 'wholesale' markets much more inexpensively, and across a much wider range of maturities and investors."

FNMA provided us with an analysis to argue that its costs might be lower if interest rates rise suddenly but has no evidence to show that if this occurs it would pass its cost savings on to the consumer. There is no reason to believe that as only one of several sources of mortgage credit FNMA would lower its prices below those of its competitors in any significant way.

FNMA's Charter Act role in serving low-to-moderate-income households

While FNMA's primary goal is to provide supplementary assistance to the secondary market, the Charter Act permits HUD to "require that a reasonable proportion of the corporation's mortgage purchases be related to the national goal of providing adequate housing for low and moderate income families, but with reasonable economic return to the corporation."[8] However, over

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[7](GAO/RCED-82-121, Aug. 31, 1982.)

[8]Section 309(h) [12 U.S.C. 1723a(h)].

time FNMA's mortgage purchase activities have gradually shifted toward the conventional single-family market and middle-income home purchasers.[9] In addition HUD has not monitored FNMA's performance in this area (see chapter 6) and its current regulations defining low- and moderate-income benefits are out of date because they are based upon the interest rates that existed in 1978 when the regulations were written.

Is FNMA adequately serving low- and moderate-income households?

It is difficult to answer this question except by inference because FNMA does not collect information on how many low-to-moderate income households it serves. Its lenders are not required to submit income characteristics on borrowers.

Several different categories of housing are defined as housing for low- and moderate-income families by HUD regulations covering FNMA. HUD regulations define low- and moderate-income housing as

--any housing financed under a variety of FHA insurance programs, targeted at lower-income households or distressed areas;

--multifamily housing projects in which tenants receive rent subsidies; and

--any single-family units purchased at a price less than or equal to 2.5 times the median area family income as determined by the Secretary of HUD.

FHA/VA loan purchases have diminished

Between 1968 and 1972 FNMA mortgage purchases were confined exclusively to FHA and VA loans. GNMA began guaranteeing FHA/VA mortgage-backed securities in 1970, providing a lower cost source of funds for these loans, while FNMA moved into the conventional mortgage market in 1972. As a result, conventional loans began to dominate FNMA purchases in 1976 and amounted to nearly 99 percent of its purchases in 1983. Thus FNMA no longer purchases any significant number of FHA loans.

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[9]FNMA has also provided a limited amount of assistance to low-income households through special demonstration projects in a number of metropolitan areas. For example, pilot urban lending projects were begun in St. Louis and Dallas in 1976 and 1977. These programs are discussed in FNMA's The Benefits of Fannie Mae, December 1984.

Assisting households through multifamily project loans

Low-income households are more likely to be renters than homeowners, particularly in metropolitan markets where FNMA activity is most prominent. Consequently, one guage of the level of FNMA's activity related to purchase of mortgages for low-to-moderate income households is the extent to which it purchases multifamily project loans. FNMA's multifamily purchases have declined largely because of changes in the way GNMA marketed subsidized loans and the government's withdrawal from multifamily housing subsidy programs.

FNMA was particularly active in the multifamily market for a brief period in the early to mid-1970's. Its activity roughly coincided with the FHA section 236 rental subsidy program for low-income households. FNMA agreed to purchase loans for this program and the FHA section 235 program at a time when other lenders were reluctant to enter the market. FNMA had committed to purchase 98 percent of the section 236 and 59 percent of the section 235 loans approved by FHA. FNMA still held nearly $6.0 billion of these loans in its portfolio in 1984.[10]

But FNMA's multifamily project activity peaked at $2.2 billion in 1974 and fell sharply to inconsequential levels by the early 1980's. Therefore, FNMA no longer purchases subsidized rental houding mortgages. Until recently, FNMA did not have authority to enter the conventional multifamily mortgage market. HUD granted FNMA limited authority to do so in October 1983. A sharp pickup in its multifamily activity occurred in the first months of 1984 in unsubsidized conventional multifamily loans. FNMA also moved to expand its multifamily activity by providing credit enhancement for tax-exempt multifamily mortgage revenue bonds and has issued or entered into agreements to issue securities to back $1.325 billion in tax-exempt mortgages. Some small portion of FNMA's present multifamily activity probably involves tenants receiving rental subsidies but in general neither of its multifamily efforts involve subsidy programs.

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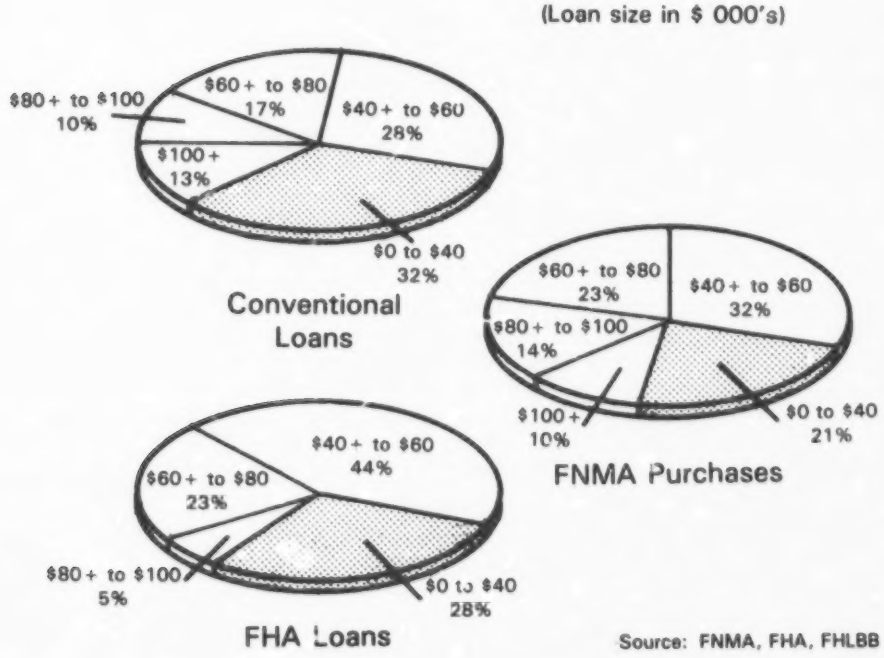
[10]Richard B. Clemmer, Fannie Mae and Its Relationship to Low-and Moderate-Income Families, GAO Symposium on FNMA, Feb. 7, 1985.

FNMA conventional single-family purchases

Figure 5.6 compares the distributions of loans purchased by FNMA in 1983 to statistics on a large sample of all conventional loans kept by FHLBB and FHA-insured loans.[11]

Figure 5.6
Distribution of Loans Purchased by FNMA With Conventional and FHA Loans, 1983



In 1983, 21 percent of FNMA 1-4 family mortgages were under $40,000 while FHLBB data indicate that 32 percent of conventional loans were for less that $40,000 and 28% of FHA loans were in this category. All conventional lenders appear to be serving a broader market while FNMA's activity is concentrated in the middle-income market. More than 55 percent of FNMA loans during 1983 and 1984

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[11] FNMA data are for 1-to-4 family conventional loans. The FHA and FHLBB data cover only single-family loans. FNMA officials could provide only a rough estimate of how many of its loans are 2-to-4 family within its 1-to-4 family portfolio. No adjustments were made because the focus of the issue is the income of the mortgage holder rather than the value of the house.

were between $40,000 and $80,000. About a quarter of all FNMA loan purchases were above $80,000. Some of the differences between FNMA, FHA, and all conventionals can be explained by limitations on FNMA purchases and FHA insurance.

--FHA loans are much more clearly aimed at the low to moderate income population than the others. FHA insurance is limited by federal regulation to loans with a maximum amount of $67,500, though larger loans (up to $90,000) are permissible in most large metropolitan areas.

--FNMA, on the other hand, can purchase somewhat larger conventional loans. The limit on its loan purchases was $108,300 in 1983 for single family homes and is currently set at $115,300. Loans which fall below these limits are known as conforming loans.

--FHLBB conventional loan data which includes loans by mortgage bankers, S&Ls, mutual savings banks, and other lenders includes loans beyond the limit imposed on FNMA. These large loans amount to about 8 percent of their loans but a more substantial 21 percent of loan volume.[12] Even with these larger loans included, these institutions still have a higher proportion of their loans in the under $40,000 category than FNMA.

Table 5.1 shows that in 1983 the average mortgage amount of one-to-four family mortgage loans for FNMA was very close to the average for all loans made in the conventional market ($60,900 for FNMA versus $59,900 for all conventional loans). Both were in turn well above the mortgage amount for unsubsidized FHA loans which averaged $50,000 in 1983. Because FNMA conventional and FHA loans differed in the downpayments which borrowers made, FNMA average sales prices were about 6 percent below conventionals. ($76,100 for FNMA versus $80,000 for all conventionals). However the much lower downpayment typical of FHA loans resulted in an average FHA purchase price ($55,500) well below FNMA's. Income statistics are available for FHA loans. In 1983 median incomes of FHA purchasers with $34,567 and $32,958 for new and existing homes respectively.

It is likely that FNMA's average loan amount and purchase price would have been somewhat higher if it were not subject to a congressional limitation of $108,300 (in 1983) on the size of loans it could purchase.

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[12]Borrowers Pay Lower Effective Interest Rates for Large Conventional Mortgage Loans (GAO/RCED-84-151, Apr. 5, 1984), p. 2.

FNMA comments on low- and moderate-income benefits

In its comments on this report and in written material it provided us earlier, FNMA says that because its portfolio contains some 2-4 family units, its average mortgage amount of $60,900 should be adjusted downward to $53,000 to be comparable to the FHA and FHLBB data that are for only single-family homes. We did not make this adjustment because FNMA provided no documentation to support such an adjustment. We considered it unlikely that its recent purchases included many 2-4 family mortgages. There is also no reason to conclude that per unit mortgage amounts for 2-4 family homes are not significantly lower than those for single homes since such units are often in older, lower-cost neighborhoods.

Even if FNMA's adjustment was correct it would mean that the average per unit mortgage of $53,000 is somewhat higher than the $51,800 average for all conventional conforming loans in the FHLBB data (see table 5.1).

Table 5.1

Comparison Of Calendar Year 1983 Average Mortgage Amounts And Sales Prices

	Average mortgage amount	Average sale price	Average loan-to-value ratio
FNMA[a]	$60,900	$76,100	.80
Conventional (FHLBB)[b]			
All loans	59,900	80,900	.74
Conforming loans[c]	51,800	70,000	.74
FHA (203b)[d]	50,000	55,500	.90

[a]Federal National Mortgage Association averages for 1-4 family unit mortgages.

[b]Federal Home Loan Bank Board, yearly totals of monthly data, all loans, all lenders, for 1-family-unit mortgages.

[c]In calendar year 1983 conforming loans are those with mortgage amounts of $108,300 or less.

[d]Federal Housing Administration, unsubsidized section 203b insurance program for 1-family-unit mortgages.

Regulatory definition of low- to moderate-income housing is probably outdated

The regulations, issued in March 1979, also said that if FNMA's purchases of loans on low- and moderate-income housing fell below 30 percent, then the Secretary of HUD could set goals for such purchases. The factor of 2.5 times income used to establish price has not changed since it was devised. Thus using the national median income for 1984 of $27,000, homes priced under $67,500 would qualify as housing for low-to moderate-income families. With a downpayment of 20 to 25 percent, which is typical, such a home would carry a mortgage of about $50,600 to $54,000. In many metropolitan areas, the median income is higher than the national average.

Thus in such areas the maximum price of a home that would be classified as low- to moderate-income would be much higher. Since well over half of FNMA's mortgage purchases in 1984 were valued under $60,000, FNMA very likely met the requirements that were based on 1978 interest rates.

However, mortgage interest rates have risen considerably since those regulations were passed in 1978. Since higher interest rates mean buyers need higher incomes to qualify for loans, FNMA now can meet the 30 percent rule by serving families with higher income levels. While FNMA may be meeting the requirement as defined in federal regulations, it is not clear that the regulations define the same income group envisioned in 1978. For illustration, table 5.2 shows the minimum incomes needed to qualify for loans on homes costing 2.5 times the median income in a variety of metropolitan areas. Many of these areas are those in which FNMA is known to be particularly active. The mimimum qualifying incomes calculated exceed the median family income for these metropolitan areas by 6 to 26 percent depending upon the downpayment assumed.

Therefore, the regulation's definition of low- to moderate-income would include many families whose incomes are not generally thought of as low-to moderate incomes. Thus, FNMA can readily meet the low-to-moderate-income requirement in the regulations even with the heavy concentration of its activities in the mid-range of the mortgage market.

Table 5.2

HUD Defined Low-to-Moderate-Income Housing Limit
Compared to Median Income for Selected SMSAs (1984)

Standard metropolitan statistical area	A Median family income[a]	B Low to moderate priced housing limit[b]	C Minimum income needed to qualify for "moderate" priced home assuming[c] 5% Down	D 10% Down	E 20% Down
San Francisco	$34,000	$85,000	$42,800	$40,600	$36,100
San Jose	36,900	92,250	46,400	44,200	39,100
San Diego	27,500	68,750	34,600	32,700	29,100
Dallas	$30,200	$75,500	$38,000	$36,000	$32,000
Houston	34,600	86,500	43,500	41,300	36,700
San Antonio	23,600	59,000	29,700	28,100	25,000
Ft. Lauderdale	$26,300	$65,750	$33,100	$31,200	$27,800
Miami	25,100	62,750	31,600	29,900	26,600
Tampa	22,200	55,500	28,000	26,544	23,500
Detroit	$32,500	$ 81,250	$40,900	$38,800	$34,400
Atlanta	28,300	70,750	35,600	33,700	30,000
Stamford, Ct.	47,600	119,000	59,900	56,900	50,400
Columbus, Ga.	20,500	51,250	25,800	24,400	21,700
U.S. Average	$27,000	$67,500	$34,000	$32,200	$28,700

[a]Median family income for 4-person households in 1984 as defined by HUD Office of Economic and Market Analysis, Policy Development and Research.

[b]Home price based on 2.5 times median family income as specified in HUD regulations.

[c]Assume 5, 10 or 20-percent downpayment, 13-percent interest rate, 30-year term and 28 percent of gross income available for payment of principal interest, tax, and insurance. The average downpayment on an FHA loan in 1984 was about 10 percent and for FNMA the average downpayment was about 20 percent. Five percent down is the lowest qualifying down payment for loans purchased by FNMA.

FNMA's effect on lowering the cost of mortgage credit and increasing mortgage credit

Although there is some difference of opinion among housing economists, it is likely that the federal credit agencies, including FNMA, have tended over time to make funds more available to housing and reduce the cost of housing credit relative to other forms of borrowing such as corporate debt.

At one end of the spectrum, economists contend that unsubsidized "agency" activity will have no effect on the quantity of funds flowing to the mortgage market or interest rates because funds flow freely between sectors of the credit market. At the other extreme, the view exists that credit rationing and market imperfections are so pervasive that every dollar of "agency-generated" credit translates into direct gains for the mortgage market. Hendershott and Villani[13] indicate that the extent to which agency activity "crowds out" other types of borrowers depends on the relative responsiveness of mortgages and other types of securities to changes in price. They tested this hypothesis with results from simulations of a flow-of-funds model for the 1967 to 1976 period and concluded that about 85 percent of federal credit agency activity does not support the housing market. Thus, for every billion dollars that credit agencies, such as FNMA is perceived to attract to the mortgage market, a net infusion of about $150 million into the mortgage market was realized, meaning that $850 million would be substituted for other mortgage market activities.

With respect to reducing interest rates, their simulations produced more significant results. Their model yields an 87-basis-point reduction in the yield spread between corporate bonds and home mortgages as the result of the federal agencies. This result does not necessarily imply that mortgage rates were lowered by 87 basis points but that the combined impact of increased interest rates for corporate securities and decreased rates for mortgages was about 87 basis points.

During the 1967-1976 time frame, FNMA's share of government agencies' activity varied. In the earlier years it was the dominant government actor, but by 1976 GNMA's activity was larger. Hendershott and Villani made no attempt to assign differing values to the interest rate reduction effects of the individual agencies.

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[13]Patric H. Hendershott, and Kevin Villani, "The Federally Sponsored Credit Agencies: Their Behavior and Impact," Capital Markets and the Housing Sector: Perspective on Financial Reform, R. M. Buckley, J. A. Tucillo, and K. Villani, eds., pp. 291 and 309, 1977.

A similar conclusion was reached by Jacobe and Thygerson. They attribute the decline in mortgage rates relative to corporate bond rates to two principal causes:

1. Improper evaluation by investors of the risk associated with default loss on mortgages in earlier years.

2. The efforts made by the federal government to attract mortgage funds through the preferred borrowing position of government-related agencies like FNMA, FHLMC, and GNMA.

These impacts could be expected to diminish in the future. Deregulation of the thrift industry and other changes have led to closer links between the mortgage and credit markets. Thus, to the extent that the interest rate differential that existed in the early 1970's between mortgages and other securities reflected in large measure the institutional rigidities and market imperfections that existed, the federal agencies compensated somewhat for these imbalances. But, as those rigidities have been eliminated, this particular potential impact of agencies on the yield differential between mortgages and other securities has likely been reduced. FNMA's impact is also relatively smaller because it now represents a smaller overall share of the mortgage market and of government agency activity in the market.

RESPONSIBILITIES AND RESTRICTIONS LIMIT FNMA ACTIVITIES AND FLEXIBILITY

Congress gave FNMA special privileges to help it accomplish certain public purposes. While FNMA's privileges provide it several financial advantages in conducting its secondary market activities, the corporation does not have the freedom other privately owned corporations enjoy in managing its business. FNMA's special privileges are linked to certain operating restrictions imposed by its congressional charter. The Charter Act limits FNMA to one line of business--the secondary mortgage market. It is further limited in the type and size of loans it can purchase or guarantee and must comply with regulations issued by both Treasury and HUD. In section 301(a) of the act (12 U.S.C. 1716(a)), Congress authorized FNMA to

> ". . . provide supplementary assistance to the secondary market for home mortgages by providing a degree of liquidity for mortgage investments, thereby improving the distribution of investment capital available for home mortgage financing."

The Charter Act, however, does not authorize FNMA to diversify into other industries beyond the secondary mortgage market. FNMA, therefore, is subject to the risks and uncertainties associated with focusing on a single industry.

Some federal regulations and oversight restrictions have been eased

The Charter Act also limits how FNMA can conduct its secondary market operations and provides the Secretaries of HUD and Treasury with substantial controls over the corporation. The Charter Act grants HUD principal oversight and rulemaking responsibility to ensure that FNMA carries out the purposes of the act, while Treasury generally controls FNMA's issuance of debt securities in the credit markets.

According to a FNMA senior vice president, the corporation devotes substantial staff time responding to HUD and Treasury requirements. In some cases FNMA has been unsuccessful or experienced delays in gaining congressional or regulatory approval for programs that its management thought would strengthen its financial position. In recent years, however, Congress has eased some constraints, thus improving FNMA's operating flexibility.

For example, the Charter Act authorizes FNMA--subject to the approval of the Secretary of HUD--to purchase conventional mortgages but establishes dollar limits and other restrictions on the mortgages it can purchase.[14] FNMA purchase limitations include a $115,300 ceiling on the mortgage balances of single-family residences. Although the ceiling is adjusted periodically to reflect changing housing prices, FNMA is denied access to mortgages of higher income homebuyers--a potentially profitable market. In 1983 FNMA estimated that about 21 percent of the total 1983 and 1984 dollar volume of mortgage originations was in excess of the FNMA statutory limits.

The Charter Act also requires FNMA to obtain HUD approval before it implements new programs to purchase, sell, or otherwise deal in conventional mortgages, home improvement loans, and mortgages secured by liens on manufactured homes.[15] As discussed in detail in chapter 6, HUD's general regulatory powers encompass virtually all aspects of FNMA's activities. HUD has approval authority over financial aspects of FNMA, including its debt-to-capital ratio (which enables HUD to limit FNMA's borrowing unless FNMA acts to adjust its debt leverage) and the issuance of stock and debt obligations convertible into stock. Furthermore, HUD regulations require a variety of written reports.

The Charter Act also assigns the Secretary of the Treasury specific regulatory functions over FNMA. The Treasury must

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[14]Section 302(b)(2) [12 U.S.C. 1717(b)(2)].

[15]Section 302(b)(2), (3), (4) [12 U.S.C. 1717(b)(2), (3), (4)].

approve the type, amounts, maturities, and interest rates of obligations issued by FNMA.[16] The act also requires that Treasury approve the issuance of mortgage-backed securities.[17]

In recent years, federal actions have prevented or delayed FNMA from undertaking certain business activities. In 1983, for example, FNMA was unsuccessful in seeking amendments to the Charter Act permitting up to 20 percent of FNMA's annual secondary market activity to be in residential mortgages without dollar mortgage limits and in the purchase of non-residential mortgages serving the needs of neighborhood residents.[18]

FNMA officials told us that Treasury regulations inhibit the corporation from tapping lower-cost credit markets. As part of the Tax Reform Act of 1984 (Public Law 98-369), Congress removed the 30-percent tax withholding requirement on foreign investment in U.S. debt. This enabled FNMA and other corporations to borrow funds directly in the overseas market. Unlike other privately owned corporations, however, FNMA is prohibited by regulation from issuing unregistered or bearer debt securities overseas. According to FNMA, if it issued overseas bearer debt, it could tap a larger share of the foreign retail market and obtain funds at lower cost.[19] FNMA estimates that this costs it approximately $25-50 million per year.

More recently, Congress acted to reduce regulatory delays and increase FNMA's flexibility in meeting market conditions. For example, in part, the Secondary Mortgage Market Enhancement Act of 1984 (Public Law 98-440), requires HUD to respond within 45 days to any request for approval or other action under the Charter Act, with a possible 15-day extension, and authorizes FNMA to purchase and deal in subordinate lien mortgages without requiring regulatory approval. The legislation also removed, at FNMA's request, HUD's approval authority over new FNMA debt obligations after September 30, 1985, since Treasury had overlapping oversight.

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[16]Section 304(b) [12 U.S.C. 1719(b)].

[17]Section 304(d) [12 U.S.C. 1719(d)].

[18]Statement by David O. Maxwell, Chairman and Chief Executive Officer, FNMA, before the House Subcommittee on Housing and Urban Affairs, May 5, 1983, Senate Hearing 98-346, pp. 84, 100-01.

[19]FNMA, The Federal Regulation of Fannie Mae, January 1985, p. 4.

FNMA's older loans impact profitability

A large segment of FNMA's assets consists of mortgages with net yields substantially less than current market interest rates and has contributed to its financial troubles in recent years. FHA/VA mortgages purchased primarily before 1980 are a major source of the problem. According to a FNMA spokesperson, as of December 31, 1984, FNMA had $34 billion in FHA/VA mortgages, representing 39 percent of its total portfolio. The mortgages had an average net yield 248 basis points below the average cost of FNMA's total debt.

A small portion of this FHA/VA portfolio was obtained under conditions beyond FNMA's control. In 1968 FNMA inherited over 500,000 FHA/VA mortgages worth about $7 billion when it became a private corporation. Over the past 16 years, many of those mortgages have been substantially amortized or paid off. Therefore, it is unlikely that this original portfolio has a significant effect on FNMA's current financial condition. Consequently, most of the burden associated with FNMA's FHA/VA portfolio stems from purchases it made since it became a private corporation.

THE FEDERAL GOVERNMENT GRANTS FNMA SUBSTANTIAL FINANCIAL BENEFITS

FNMA receives substantial financial advantages from the federal government. The Charter Act confers special privileges to help it accomplish public purposes through its secondary market operations. While FNMA does not receive direct cash outlays from the government, the combined effect of its special privileges and close federal ties amounts to a significant, but difficult to measure, financial benefit. Most importantly, FNMA's federal sponsorship results in the financial community perceiving its debt offerings as having federal "agency status." This enhances credit market acceptability of FNMA debt securities and allows it to raise large amounts of funds at relatively lower cost. The federal relationship also creates the market perception that FNMA debt carries an implicit federal guarantee. The major federal links contributing to its perceived agency status include

--the U.S. Treasury "backstop" borrowing,

--federal designation of FNMA obligations as acceptable investments for entities under federal control,

--federal exemptions from state and local income taxes and SEC registration requirements and fees,

--federal oversight and public purposes, and

--presidential appointment of some corporate board members.

Treasury "backstop" borrowing

A major contributor to FNMA's perceived agency status is its ties with the U.S. Treasury. Section 304 (c) of the Charter Act [12 U.S.C. 1719] authorizes the Secretary of the Treasury to purchase up to $2.25 billion of FNMA's obligations. This authority, which is similar to that granted and Federal Home Loan Banks, enhances FNMA's credit standing and

> ". . . constitute[s] government recognition of the significance of the corporation's operations to the national interest aspects of the mortgage financing industry."[20]

FNMA's access to possible Treasury "backstop" financing is not a line of credit, but a "right to ask" for assistance up to $2.25 billion. As a result, the monetary value of the $2.25 billion backstop is difficult to measure since FNMA does not have ready access to the funds, as is often the case with a line of credit, and conditions for obtaining the money may be set by the Secretary. The Secretary's authority extends to structuring the terms and conditions when purchasing FNMA debt obligations. While the Treasury backstop is outstanding at any time, the United States is not legally obligated to finance FNMA's oprations in any manner. FNMA has not borrowed from the Treasury since it became a private corporation in 1968.

The primary benefit FNMA receives from the backstop appears to rest with the Treasury "connection" and, to a lesser ertent, the actual dollar assistance presently available to FNMA. In a severe financial crisis, many FNMA observers believe the United States would extend greater financial assistance to FNMA than currently authorized because of its public purpose role and its dominant position in the secondary market. This leads some observers to view FNMA debt securities as carrying an implied federal guarantee.

Speaking in economic terms, however, the potential impact on FNMA of $2.25 billion in additional financing has probably diminished because FNMA's assets and liabilities have increased substantially since it went private. Its mortgage portfolio, for

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[20]Report of the Committee on Banking and Currency, U.S. Senate, Report no. 1123, 90th Congress, 2nd Session, May 15th, 1968, p. 79.

example, has increased eightfold from December 31, 1969 ($11.0 billion), to December 31, 1984 ($87.9 billion),[21] while the backstop authority has remained unchanged at $2.25 billion.

FNMA obligations are acceptable investments for financial entities subject to federal control

Another factor contributing to FNMA's perceived agency status is federal designation of FNMA obligations as acceptable investments for entities such as banks and savings and loan associations. Such designation provides FNMA a large market for its securities that, according to a FNMA senior vice president, is one of the most important federal benefits it receives. A broad-based market enhances FNMA's ability to sell huge amounts of debt on a continuous basis at a variety of maturities and in a variety of forms.

Section 311 of the Charter Act [12 U.S.C. 1723(c)] makes FNMA obligations eligible investments and security for all fiduciary trusts and public funds subject to federal control. Federal Savings and Loan Insurance Corporation (FSLIC)- and Federal Deposit Insurance Corporation (FDIC)-insured institutions, for example, can invest in FNMA obligations without holding to rules governing asset diversification. The same preferential treatment is given to securities guaranteed by GNMA--a government-owned corporation--thus reinforcing the view that FNMA debt is connected with the federal government. All other companies issuing MBS and CMO's in the secondary market were given this same privilege by the Secondary Mortgage Market Enhancement Act. Other characteristics that increase FNMA debt marketability include its eligibility as security for advances to member banks of the Federal Reserve banks. In addition, savings and loan associations are permitted to invest in FNMA securities to meet liquidity requirements prescribed by the Federal Home Loan Bank Board. FNMA securities are also legal investments for federal credit unions. Furthermore, the Internal Revenue Service (IRS) allows real estate investment trusts to regard FNMA obligations as "government securities" to meet IRS requirements that 75 percent of their total assets must consist of real estate assets, government securities, or certain other assets.[22]

Several of these sources of investment funds accounted for the majority of FNMA debenture purchases over the last several years. As indicated in figure 5.7, investments by commercial banks, thrift institutions, trusts, and estates accounted for 61 percent of FNMA debenture offerings between 1979 and 1983.

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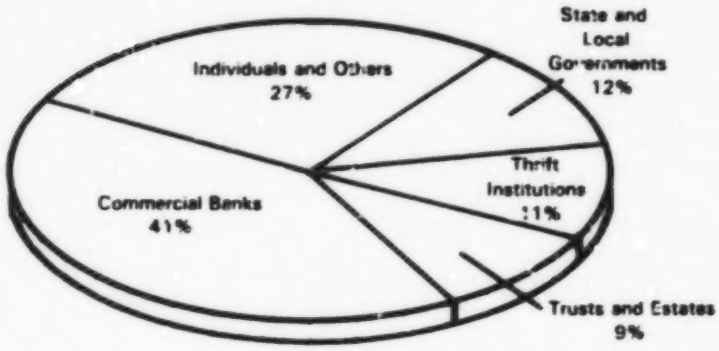
[21] FNMA 1969 Annual Report, p. 18; FNMA, 1984 Fourth Quarter Memorandum to Investors and Financial Analysts, p. 21.

[22] IRS Revenue Ruling 64-85.

Figure 5.7
Initial Purchasers of FNMA
Debentures for the Years 1979-83
($8.0 billion issued)



Source: FNMA, Fannie Mae as a Portfolio Investor,
October 1984, pg. 21

The value of "agency status" is difficult to quantify

The cash value of FNMA's perceived agency status essentially depends on how much its borrowing costs would change without this privilege. Without "agency status," however, a number of difficult-to-predict variables could affect FNMA's credit standing and, thus, cost of funds. These factors include general economic conditions, corporate performance, and whether FNMA's statutory responsibilities change in the future. Consequently, while FNMA officials and financial experts agree that the perceived agency status gives FNMA a valuable credit market borrowing advantage, the size of the advantage can vary under different economic and regulatory scenarios. Nevertheless, as discussed below, a change in FNMA's present high credit standing to that of medium-quality investment securities could cost it millions of dollars annually and possibly put it out of business.

One measure of FNMA's favored-borrowing position is the small difference, or "spread," in yield between FNMA and U.S. Treasury debt securities that are generally reputed to be about as certain of payment as any obligations known and usually command a yield less than any security of comparable maturity and tax position. Credit market investors have generally purchased FNMA

securities at yields slightly higher than Treasury securities. For example, FNMA 6-month debt issues traded an average of 22.5 basis points (.225 percentage points) higher than comparable Treasuries in 1983 and 1984.

Figure 5.8 illustrates the monthly spread between FNMA and Treasury 6-month obligations for the 8-year period January 1977 through December 1984. Although the spread was narrow throughout most of the period, the spread widened considerably in 1981-1982, an era of historic high interest rates and at one time reached nearly 200 basis points. During this period FNMA posted operating losses totaling $295 million, but the credit markets remained receptive to FNMA securities, albeit at higher costs to FNMA. In 1981 and 1982, the corporation was able to raise about $31 billion in bonds and debentures and over $64 billion in notes.

FNMA is widely perceived by the financial community as being backed by a moral obligation of the federal government. This is despite a statutory requirement that FNMA must insert language in all of its obligations clearly stating that neither the principal nor interest of such obligations is guaranteed by the federal government. (12 U.S.C. 1719(b)) The most recent credit opinions of two major credit rating services--Moody's Investor's Service, Inc., and Standard and Poor's Corporation--have assigned the highest rating possible (triple-A) to FNMA's mortgage-backed securities and unsecured senior debt debentures.[23] To investors, a triple-A rating means that the debt-issuing company has a high capacity to pay interest and repay principal. To FNMA, a triple-A rating means lower borrowing costs and a broader market for its securities than companies with lower credit ratings.

FNMA has been able to retain this high rating although it has suffered losses in 3 of the last 4 years. Similar circumstances experienced by private corporations without federal connections would certainly have resulted in a down-grading of its credit rating. Moody's opinion cited several factors that it states "has reinforced the perception of the U.S. Government's moral obligation to stand behind FNMA."[24] According to this Moody's review, FNMA's special privileges, public purposes, size, scope of activities, and significance to the housing and finance industries qualify it for further government backing. The review further states that

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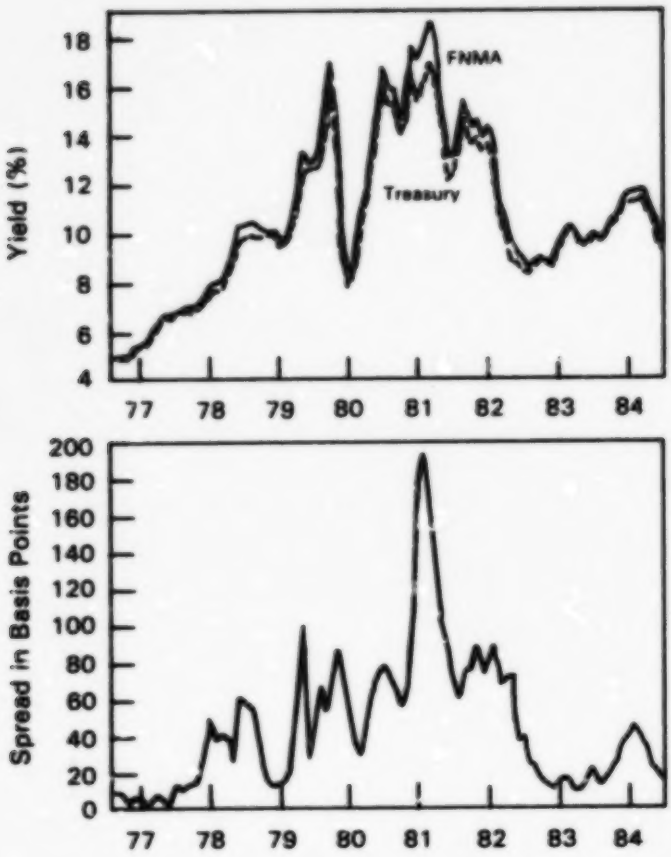
[23]Standard and Poor's Corporation, Credit Week, October 31, 1983, pp. 713-15; Moody's Investors Services, Inc., Moody's Bond Survey, March 12, 1984, p. 4506.

[24]Moody's Bond Survey, p. 4508.

"The impact of a default by FNMA, would have far reaching repercussions which would adversely affect both foreign and domestic markets. The U.S. Government itself owns a substantial amount of FNMA debt securities. In particular, the deposit insurance programs rely in part on investments in FNMA securities."

Figure 5.8
Average Monthly Secondary Market Quotes for FNMA and Treasury 6-Month Debt Obligations (1977-1984)



Source: Data supplied by FNMA.

Moody's also cited examples of recent federal actions that "demonstrated its willingness through legislative and regulatory action to support FNMA..."[25] when FNMA incurred severe losses in 1981-1982:

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[25] Moody's Bond Survey, p. 4509.

--October 1982 legislation changed FNMA's net operating loss carryback/carryforward tax rules.[26]

--FNMA's activities were expanded to purchase conventional second mortgage loans and issue mortgage-backed securities.

--The Garn-St. Germain Depository Institutions Act of 1982 (Public Law 97-320) authorized FNMA to issue preferred stock and HUD eased FNMA's debt-to-capital ratio.

According to FNMA officials and financial experts that we consulted, the elimination of FNMA's perceived agency status would probably result in a credit rating lower than triple-A and increase its borrowing costs. FNMA says this would prevent the company from operating its present business of purchasing mortgages for portfolio and guaranteeing MBS. Even if FNMA retained its triple-A status as a non-federally sponsored corporation, its costs would probably increase several basis points as indicated in figure 5.9. The figure shows that U.S. agency medium-term securities since 1982 have had at least a 10-basis-point yield spread advantage over comparable industrial triple-A debt. Lower-graded industrial debt is also presented for comparative purposes.

According to Moody's rating opinion and our analysis in chapters 3 and 4, FNMA's high debt leverage, large asset/liability maturity mismatch, and credit risk continue to pose a threat to FNMA's profitability. Therefore, without perceived agency status it is clearly possible that FNMA's credit rating would be much lower than triple-A. This could further increase FNMA's debt costs. An Office of Management and Budget (OMB) estimate illustrates FNMA's borrowing advantages over double-A rated corporate debt. OMB estimated that for the years 1975-1982, FNMA 7-year bond yields averaged 63 basis points below double-A rated corporate bonds with 7-10 year maturities.[27] In figure 5.9, the comparison of 10-year U.S. agency and double-A rated industrial securities indicates that agency securities had at least a 20-basis-point advantage in recent years. But without the perceived agency status, FNMA's credit standing could be lower. FNMA's chief economist told us that mortgages are in general the equivalent of medium-grade investment securities (those with a Baa rating). If FNMA's credit standing dropped to this level, its debt costs could increase over 75 basis points as indicated in figure 5.9.

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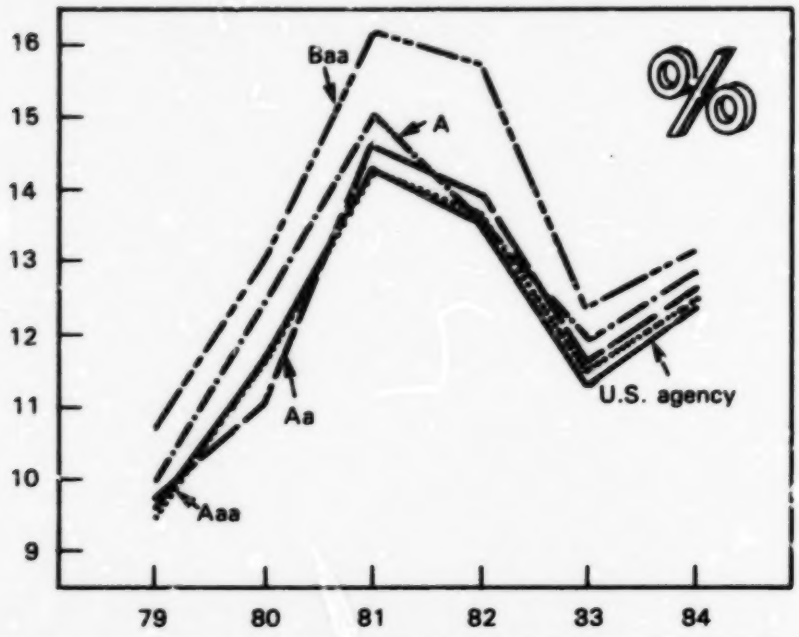
[26]The Miscellaneous Revenue Act of 1982 (Public Law 97-362) changed FNMA's previous 3-year carryback and 15-year carry forward rules--which applied to most private corporations, except depositories--to 10-year and 5-year, respectively, thus treating FNMA the same way as depositors.

[27]Senate Hearing 98-346, Subcommittee on Housing and Urban Affairs, 89th Congress, 1st Session, May 5, 1983, pp. 33-34.

Figure 5.9
Yield Comparison of Medium-Term U.S. Agencies and New Industrial Debt Obligations 1979-1984



Yield Spread (in Basis Points)	U.S. Agency Advantage (Disadvantage)					
	1979	1980	1981	1982	1983	1984
U.S. Agency vs. Aaa	(5)	(2)	(12)	13	13	12
U.S. Agency vs. As	12	(75)	26	43	30	24
U.S. Agency vs. Baa	105	171	183	221	103	76

Note: Note: Debt Obligations with 10-Year Maturities. U.S. Agencies Consist of FNMA, FHLMC, SLMA, Federal Home Loan Banks, and Farm Credit Banks.

Source: Salomon Brothers Inc., Analytical Record of Yields and Yield Spreads, Part I and II.

So, regardless of how the financial community would view FNMA as a non-federally sponsored agency, its debt cost would probably increase. However, the magnitude of the increase is dependent on its perceived creditworthiness. FNMA is highly dependent on the credit market's acceptance of its debt since it finances its mortgages with shorter term debt that must be rolled over during the term of the mortgage. As of December 31, 1984, 37.3 percent of FNMA's debt totaling $31.3 billion must be refinanced in 1985. Assuming FNMA had to refinance this debt at 1/2 percent (50 basis points) above its "agency status" preferred-borrowing rate, its debt costs would increase an estimated $157 million, which is double FNMA's 1983 net income.

However, a significant reduction in FNMA's credit rating could reduce the amount of debt it is able to sell. FNMA officials told us that loss of federal "agency" support would eliminate its ability to continue as a portfolio investor and to refinance its present holdings.

Exemption from SEC requirement saves FNMA several million dollars annually

Strengthening the widely held view of FNMA as a government entity is its exemption from registration requirements administered by the Securities and Exchange Commission (SEC). FNMA does not have to register its public debt offerings with the SEC as required by the Securities Act of 1933, nor does it have to comply with SEC disclosure and reporting requirements. In essence, FNMA debt securities have the same exempt status as U.S. securities. This privilege provides FNMA an economic advantage as well as reinforcing its "agency status."

The Securities Act of 1933 was designed to require complete disclosure of pertinent information about new corporate securities when they are offered. Federal, state, municipal, bank, railroad, and certain other securities are exempted. The act requires that non-exempt securities be "registered" with the SEC before they are publicly offered. Registration consists of paying a fee and filing with the SEC both a "registration statement," containing a large amount of information concerning the legal, commercial, and financial position of the issuer, and a "prospectus" that summarizes this information for public use. The SEC is required to delay or stop the public offering if any of the information is inadequate or misleading.

According to SEC officials who examined the reports HUD requires from FNMA, FNMA generally provides information that meets SEC reporting and disclosure requirements. The SEC exemption, however, saves FNMA several million dollars annually in registration fees. The Securities Act of 1933 [15 U.S.C. 77f] requires issuers to pay a filing fee of 1/50th of 1 percent of the price at which the securities are offered. In 1984 FNMA issued about $24.8 billion in bonds and debentures with an average maturity of 46 months. If it were required to register these securities with the SEC, FNMA would have had to pay an estimated $4.97 million in filing fees. Our estimate of FNMA's savings between 1981 and 1984 are presented in Table 5.3.

Table 5.3
FNMA Borrowing Activity and Estimated Value of Exemption From SEC Filing Fees 1981-1984 (dollars in millions)

	1981	1982	1983	1984
Bonds and debentures issued	$10,221	$20,764	$19,756	$24,836
Savings to FNMA	2.04	4.15	3.95	4.97

Source: FNMA Debt Offering Circular, Feb. 14, 1985.

FNMA exemption from state and local income taxes

FNMA is also exempt from all taxation by any state, county, municipality, or local taxing authority, except for real property taxes.[28] The exemption includes the District of Columbia where FNMA maintains its principal office. The corporation is, however, responsible for paying federal corporate income taxes.

The extent of FNMA's tax savings depends on its profitability and state and local tax policies for multistate businesses. Since FNMA does business nationwide but, according to a FNMA spokesperson, does not keep figures for revenue, expenses, and profits on a state-by-state basis, we could not develop an accurate estimate of the total state and local taxes FNMA would have paid in 1983 if it were not exempt from these taxes.

The basis on which different jurisdictions levy taxes varies considerably. In many states, for example, corporations pay a flat or graduated income tax rate based on net income, while other states base taxes on assets, stock value, or other measures. In addition, jurisdictions differ widely in the type of deductions allowed from the amount determined to be gross income to arrive at taxable net income. Furthermore, financial organizations such as banks, insurance companies, and savings and loan associations are also accorded certain special tax treatment in many states.

Nevertheless, we were able to develop a rough estimate of FNMA's state and local income tax savings by examining the ratio of all corporations' state and local income tax payments to their federal tax payments. Assuming this relationship applies to FNMA, FNMA's special tax exemption saved it millions of dollars during its profitable years. For example, we estimate that this privilege saved FNMA $5.5 million to $12.4 million in 1983, a year in which its net income was about $75.5 million. FNMA's state and

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[28]Charter Act section 309(c)(2) [12 U.S.C. 1723a(c)(2)].

local income tax saves it an estimated 4 to 9 percent of pretax income. Our methodology and estimates of FNMA tax savings for previous years are presented in appendix II.

Total state and local income taxes as a percentage of federal income taxes paid by U.S. corporations for the years 1975 through 1983 ranged from about 16 percent to 35.5 percent of federal tax payments. The average for the period was about 21 percent. Since FNMA is a financial organization, it could receive different tax treatment without its special tax exemption. Total state and local tax payments averaged 46.6 percent of total federal tax payments made by financial depositories--commercial banks, mutual savings banks, and savings and loan associations--during the years 1975 through 1983, an average considerably higher than that of all domestic corporations. But, FNMA pointed out that its federal taxes as a percent of income before taxes are higher than other financial institutions.

Government costs associated with FNMA's "agency status" and special privileges

From a budgetary perspective the financial advantages FNMA receives do not entail direct cash outlays from the federal government. The burden of these advantages, however, is borne by the federal, state, and local governments, in terms of lost fees and tax revenues, and by other borrowers who may pay higher interest rates because of FNMA's preferred place in the credit markets.[29] But the perception that the United States stands behind FNMA's debt with an implicit guarantee and the likelihood that it would extend assistance to the corporation if it experienced severe financial difficulties result in at least some risk, or contingent liability, to the government.

The value or potential cost of this contingent liability is difficult to measure since it depends on the level of risk associated with FNMA's portfolio activity, the probability that FNMA will actually require federal financial help, and the amount of risk shared by the government, FNMA, and its stockholders. It would also depend on the form of assistance the federal government would provide and, for some forms of assistance, on the size of FNMA's portfolio and outstanding debt.

The level of risk and, hence, potential costs to the federal government fluctuate over time. As noted in chapter 3, FNMA's portfolio risk is dependent on variables, some based on company

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[29]Funds that FNMA raises for housing investment using its perceived agency status are thought to divert capital from other sectors of the economy, thus raising the cost of funds in those sectors. H.M. Kaufman, FNMA and the Housing Cycle: Its Recent Contribution and Its Future Role in a Deregulated Environment, presented at a GAO-sponsored symposium, Feb. 7, 1985, pp. 10-12.

activities and others on outside economic forces (e.g., the general level of interest rates). The potential costs to the government probably peaked in 1981-1982 when interest rates were high and FNMA had large losses. During this period, FNMA's debt costs increased substantially as evidenced by a widening yield spread between FNMA and Treasury. This indicates that investors required a higher yield on their FNMA debt securities to compensate for a perceived greater risk of loss. Since that time, the corporation has taken several actions to reduce risk as outlined in chapter 3.

The federal cost of exempting FNMA from SEC registration filing fees is generally equivalent to the product of FNMA's federal tax rate and the savings it receives from the exemption. The federal cost is not the same as FNMA's savings since filing fees are an allowable business expense deduction for federal income tax purposes. As a result, we estimate that the SEC exemption cost the government $1.8 million in 1983.

FNMA's exemption from state and local income taxes, which we estimate saved it $5.5 million to $12.4 million in 1983, equals revenues foregone by state and local governments. Federal tax revenues, however, are higher because of the exemption since FNMA does not deduct state and local taxes fromits income when computing federal income taxes. In 1983, for example, we estimate that FNMA's state and local income taxes without this exemption ranged from $10.1 million to $22.8 million. (See appendix II.) Consequently, we estimate that FNMA's state and local income tax exemption increased federal tax revenues by $4.6 million to $10.4 million in 1983. This more than offset the federal cost of FNMA's SEC registration exemption.

CHAPTER 6

FEDERAL OVERSIGHT AND REGULATION OF FNMA

The Congress granted the Secretary of HUD specific and general regulatory powers over FNMA to ensure that it carried out the public purpose responsibilities of the 1968 amendments to the Charter Act. While HUD has carried out several of its oversight functions, such as issuing regulations and reviewing FNMA program requests, it has not fully exercised its oversight authority relating to auditing, reviewing, and reporting on FNMA activities. For example, HUD did not complete a required report to Congress on FNMA activities. Therefore Congress is without a clear picture of whether FNMA is achieving its public purpose responsibilities and the extent to which FNMA exposes the government to risk. This situation exists because HUD is uncertain as to what its oversight and regulatory role should be and it has not developed the staff expertise needed to oversee all FNMA activities. The Congress also granted the Secretary of Treasury certain oversight powers, including approval of FNMA debt issuances. According to FNMA, HUD, and Treasury officials, a mutually agreeable calendar schedule for borrowing has been established and off-calendar borrowings are generally routine. FNMA, however, points out some costly exceptions in Treasury approval of new debt.

The Charter Act amendments of 1968 authorized HUD to exercise general regulatory power and rule-making authority by issuing regulations, approving FNMA programs and certain debt issuances, requiring appropriate reports, and overseeing FNMA activities through audit and review. In addition, HUD may also require that a "reasonable" portion of FNMA's mortgage purchases be related to providing housing for low- and moderate-income families but only to the extent these purchases provide a "reasonable economic return."

HUD issued revised regulations in 1978 implementing the general regulatory authority of the Secretary over FNMA. HUD has also responded to various FNMA requests for new mortgage program approvals and has received various reports required from FNMA by regulation. Nonetheless, we believe that the Department's oversight performance has fallen short of what Congress envisioned in the Charter Act, in that

--HUD established a small FNMA oversight unit within the Office of General Counsel shortly after issuing revised regulations. However, the unit was disbanded in 1982. As a result since that time and during substantial changes in FMNA's operating environment there has been no staff exclusively dedicated to continually monitor FNMA's operations and performance. HUD noted in its comments that a variety of staff in OGC and other HUD offices respond to

FNMA proposals and perform analyses on an as-needed basis and that the dissolution of its oversight unit did not substantially change its level of effort.

--HUD no longer obtains the information necessary to determine if FNMA is providing a reasonable portion of its loan purchases for low- and moderate-income families. A "reasonable" portion of FNMA purchases relating to housing for low- and moderate-income families is one of the benefits envisioned in the Charter Act. At FNMA's request HUD waived the reporting requirement relating to low- and moderate-income family purchases, saying that the information was not used within the Department.

--Although HUD has audit authority and access to FNMA records, it has chosen not to utilize its audit authority in favor of FNMA's independent financial auditors. This is probably consistent with the private, but not necessarily the public-purpose, side of FNMA's identity. This is so because HUD has not directly accessed FNMA's files and records. Therefore, data on certain aspects of FNMA operations having public policy implications are not available to the government or the Congress.

--HUD did not submit a report on FNMA activities required by the Congress since 1978. Recent legislation dropped the requirement in favor of an annual report, but HUD is voluntarily preparing the originally required report.

While HUD has not completely fulfilled its legislated mandate and has not fully enforced its own regulations, many economic and market place changes have occurred that would seem to indicate a need for careful oversight. For example, the secondary markets and mortgage businesses have been restructured, and FNMA purchases have grown rapidly, thus exposing FNMA to greater foreclosure and interest rate risk. At the same time, congressional concern has been directed to the benefits and costs of FNMA's activity. A congressional need yet to be fulfilled is information and analyses that would give Congress a clear picture of whether FNMA achieves its public-purpose objective and the extent to which FNMA exposes the government to risk.

In fact, HUD senior officials told us that

--HUD does not have the staff expertise or capability to adequately oversee and regulate FNMA;

--HUD's oversight and regulatory role is not well defined; and, therefore,

--HUD is uncertain over what should be regulated and how to regulate FNMA activities.

Figure 6.1
Public and Private Forces Affecting FNMA

Congress
• Enacted legislation creating FNMA
• Provides legislative oversight
HUD
Market Forces
• Has general regulatory authority over FNMA
• Approves new FNMA programs
• Has authority to audit FNMA books and transactions
• May require FNMA to submit reports on its activities
• Must report annually to Congress on FNMA activities
FNMA
• General level of economic activity
• Credit markets
• Loan origination
• Building activity
• Investors
• FNMA shareholders
Treasury
President of U.S.
• Approves FNMA debt issues
• Has authority to purchase $2-1/4 billion of FNMA debt
• Appoints 5 of 18 members to FNMA board of directors
• Can remove any board member for good cause

FNMA's OPERATING ENVIRONMENT

FNMA's operating environment is a function of market forces, its responsibility to private investors and shareholders, and its governmental connections. Figure 6.1 depicts these major influences. The current environment has developed through FNMA's creation by the Charter Act, HUD and Treasury regulation, FNMA programs and activities, FNMA's stockholders and board of directors, and the interaction among these and others. The role FNMA was expected to play influenced the development of the current oversight and regulatory environment. The interaction between public-purpose and private for-profit roles is illustrated within the current environment. The public-purpose role corresponds to the oversight and regulatory role carried out by the President, Congress, HUD, and Treasury. The private for-profit role corresponds to the oversight and regulation present in the board of directors, shareholders, and the impact of the marketplace.

FNMA's operating environment is not unique

FNMA is only one of the federally created governmental or quasi-governmental organizations operating in similar environments. We chose two other institutions in the secondary mortgage market--the Government National Mortgage Association (GNMA) and the Federal Home Loan Mortgage Corporation (FHLMC)--and the Student Loan Marketing Association (SLMA), which serves as a secondary market buyer and seller of student loans--to compare to FNMA. Figure 6.2 below summarizes the primary purposes of the four institutions, and figure 6.3 sets out some basic organizational similarities and differences of FNMA, GNMA, FHLMC, and SLMA.

One characteristic that links FNMA to the government is its oversight and regulatory relationship with HUD. As shown in figure 6.3, the other agencies also have direct links to the federal government and an oversight agency. For example, FHLMC activities are supervised by the Federal Home Loan Bank Board.

Figure 6.2

FNMA, GNMA, FHLMC, and SLMC: Basic Purposes and Functions

FNMA

- Purchases single-family and multifamily FHA, VA, and conventional mortgages as a long-term investment.
- Provides additional liquidity to the mortgage market and improved distribution of funds through its secondary market operations.
- Guarantees securities backed by mortgages representing interests in FHA and VA, and conventional mortgages from its portfolio and those pooled by lenders.

FHLMC

- Purchases FHA and VA, conventional single-family, home improvement, and multifamily fixed-rate loans for mortgage backed securities.
- Enhances the liquidity of mortgage investments and increases the availability of funds through its secondary market functions.

GNMA

- Purchases subsidized single-family and multifamily FHA, VA, and, at times, conventional mortgages.
- Guarantees securities backed by pools of mortgages, representing interests in FHA, VA, and FmHA mortgages.
- Supplies and stimulates, through these secondary market mechanisms, mortgage credit that furthers the federal government's housing subsidy programs.

SLMA

- Purchases student loans from and makes secured loans to banks and other private lenders.
- Stimulates private financing for student loans under the federally guaranteed student loan program, through these secondary market activities.

The three entities are somewhat similar to FNMA in that, for each, Congress has assigned oversight and regulatory powers to some federal agency. The differences are apparent only if the implementation of the oversight and regulatory powers is examined. For example, HUD, through Charter Act authority, may examine and audit FNMA's books and financial transactions and require FNMA to report on its activities. Similar audit authority was also granted to the other agencies, as indicated in figure 6.3. One difference, however, is that we are excluded from audit authority over FNMA.[1]

Another major difference relates to federal backing or guarantee of debt. FNMA does not have an explicit federal guarantee regarding its debt issuances or outstanding mortgage-backed securities. However, an implicit guarantee exists due to FNMA's links to the federal government. As noted earlier (see chapter 5), due to the perceived federal ties, the marketplace has accorded FNMA "agency status" regarding debt issuance. This perceived agency status differs among the other agencies. For example, SLMA's ties to the government are more explicit based on actual borrowing from the Federal Financing Bank of $5 billion and the Treasury discretionary authority to purchase $1 billion of outstanding obligations. Likewise, GNMA ties to the government are quite explicit in that it receives appropriations and is not subject to income taxes.

HUD HAS NOT FULLY EXERCISED ITS OVERSIGHT AUTHORITY AND RESPONSIBILITIES

While HUD has carried out some of its oversight activities, it has not carried out others required or suggested in the Charter Act. HUD, for example, has issued regulations, reviewed FNMA program requests, and drafted a report on FNMA activities. However, HUD has not completed the legislatively required report to Congress on FNMA activities, exercised its audit authority over FNMA, nor has it actively enforced its own regulations. As a result, Congress does not have adequate information and analyses from HUD that would help determine how FNMA is carrying out its public-purpose role and the extent to which FNMA is exposing the government to risk through the implicit federal guarantee.

The 1954 Charter Act envisioned converting FNMA's secondary market operations to private ownership. This concept was the basis for the 1968 legislation. Despite the transfer of ownership

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[1]Section 810(c) of the 1968 Charter Act amendments, which contained GAO audit authority, was repealed by section 806(1) of the Housing and Community Development Act of 1974, Public Law No. 93-383, 88 Statute 728. The reasons for the repeal were not discussed in the Senate, House, or conference reports. Without such audit authority, we do not have access to FNMA records.

FIGURE 6.3

Organizational Comparison of FNMA, GNMA, FHLMC, and SLMA

Agency	Ownership	Management control	Federal oversight and regulations	How activities are financed	Federal guarantees	Audit authority
FNMA	Stockholders	Board of Directors --5 appointed by the President of the U.S. --13 elected by stockholders.	Secretary of HUD through issuance of regulations and program approval. Secretary of Treasury through approval of debt issuance. No authority over FNMA day-to-day management.	Cash flow from mortgage portfolio and issuance of debentures and short-term discount notes, and fees from commitments and guarantees.	NONE. Charter Act authorizes $2.25 billion backstop authority at discretion of Secretary of Treasury.	Secretary of HUD has audit authority. By regulation, HUD may accept report of FNMA independent accountants. GAO specifically excluded from audit authority.
GNMA	Government agency within HUD	President of GNMA appointed by President of the U.S. and other officers appointed by Secretary of HUD.	Secretary of HUD and the Congress through the budget process and regulations.	Treasury borrowing, cash flow from portfolio and fees from commitments and guarantees.	Backed by full faith and credit of the U.S. government.	Secretary of HUD and GAO have audit authority.
FHLMC	Member savings and loans of the Federal Home Loan Bank System	Board of Directors --3 members of the Federal Home Loan Bank Board --Advisory Committee selected by member banks.	Board of Directors, through approval of programs and budgets.	Sales of mortgage-backed securities and issuance of debt.	NONE. Can use assets of member institutions to provide additional capital if needed.	GAO has audit authority.
SLMA	Stockholders	Board of Directors --7 appointed by the President of the U.S. --14 elected by stockholders.	Secretary of Education through regulation. Secretary of Treasury through approval of debt issuance.	Cash flow from loan portfolio and issuance of debt obligations. Borrowing from the Federal Financing Bank and private issuances.	Initial borrowings of $5 billion from FFB are backed by U.S. government. Backstop authorized to purchase $1 billion of obligations at discretion of Treasury.	Secretary of Education through independent accountants. GAO does not have audit authority.

and control into private hands, Congress recognized that safeguards were needed to ensure that the public purposes of FNMA would be carried out by the newly created, government-sponsored, private corporation. The Charter Act, indicates that Congress intended a safeguard to be the authorities of the Secretaries of HUD and Treasury to oversee FNMA activity after its transfer to private ownership. Figure 6.4 shows the specific authorities included in the Charter Act.

Under section 309 of the Charter Act, the Secretary of HUD is empowered to issue rules and regulations to ensure that the act's purposes are accomplished, review FNMA's financial operations, and prepare a study of the extent to which FNMA meets the purposes of the Charter Act. These regulatory powers are, however, subject to two limitations:

--Certain areas of the regulations must be consistent with maintaining a "reasonable economic return" to FNMA and a "fair rate of return" to its shareholders.

--Regulations may not extend to FNMA's internal affairs, such as personnel, salary, and other usual corporate matters, except where the exercise of such powers is necessary to protect the financial interests of the government or is otherwise necessary to ensure that the purposes of the Charter Act are carried out.

The Charter Act gave HUD considerable discretion in the exercise of its other oversight powers. For example, the act states that HUD may

--require that a reasonable portion of FNMA's mortgage purchases be related to the national goal of providing adequate housing for low- and moderate-income families, but with reasonable economic return to FNMA;

--examine and audit FNMA's books and financial transactions; and

--require FNMA to report on its activities as the Secretary deems advisable.

Figure 6.4
Authority of Secretaries of HUD and Treasury over FNMA

Nature of authority	Charter Act provision HUD	Treasury
Approval of purchase of conventional mortgages	302(b)(2)	
Approval of higher limit on maximum obligation of multiple-dwelling, conventional mortgages purchased by FNMA based on geographical costs	302(b)(2)	
Approval of purchase of home improvement loans	302(b)(3)	
Approval of purchase of mortgages secured by liens on manufactured homes	302(b)(4)	
Level of capital contributions from mortgage sellers	303(b)	
Level of capital contributions from mortgage servicers	303(c)	
Level of dividends	303(c)	
Approval of type, amounts, maturities, and interest rates of general obligations		304(b)
Debt-to-capital ratio	304(b)	
Discretion to purchase general obligations (Approval of backstop borrowing authority)		304(c)
Approval for sale of mortgage-backed securities		304(d)
Approval for sale of subordinated obligations		304(e)
General regulatory power; approval of stock and obligations; operations directed to housing for low- and moderate-income families; audit power, report on financial operations	309(h)	
Approval of all issuances of stock and debt obligations convertible into stock	311	

HUD has not reported to Congress

HUD's regulatory powers were amended by 1977 legislation to include a requirement that a study on FNMA activities will be completed and transmitted to the Congress on or before July 1, 1978. The Congress again amended the Charter Act in the Secondary Mortgage Market Enhancement Act of 1984 to require that HUD report annually (by June 30) on FNMA activities. It deleted the legal requirement for the 1978 report, but the Senate Conference report nonetheless asked that the report be prepared.

HUD has attempted at various times to prepare a report to Congress; however, each attempt resulted in the report not being issued. For example, an internal HUD document shows an early draft report was prepared shortly after the 1977 legislation. However, according to the HUD document, the report was not accepted since it presented nothing significant concerning FNMA operations. Therefore, HUD chose not to send the report to Congress. Subsequent draft versions of the reports have also not been completed and sent to Congress. HUD documents show that it made no detailed critiques of its reports to make them acceptable for issuance to Congress, with at least five separate draft reports being prepared but never completed. HUD's General Counsel informed us that it is currently completing the report that Congress asked for in 1984.[2]

HUD regulations

Revised regulations implementing HUD's authority over the secondary market operations of FNMA became effective September 14, 1978. HUD prepared a comprehensive preamble to the revised regulations. In the preamble HUD stated that no previous administration had attempted to clarify the relationship between HUD and FNMA by developing a detailed regulatory framework and that Congress had indicated dissatisfaction with HUD's failure to exercise general oversight responsibility over FNMA. HUD also included an excerpt from a statement by the Chairman of the Senate Committee on Banking, Housing, and Urban Affairs:

> "FNMA's charter is entirely clear that it has public responsibilities including the support of low and moderate income housing. The conduct of these responsibilities is to be overseen through the appointment of one-third of the FNMA board of directors by the President of the United States and, more importantly, through oversight by HUD. . . ."

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[2]HUD is now working on the report to the Congress legislated in 1977.

"It is the Committee's impression that, in the case of FNMA, this public oversight function has been neglected by HUD, leaving this massive corporation to conduct its affairs in any manner it sees fit."[3]

Internal correspondence from the HUD General Counsel to the Secretary of HUD dated September 1, 1978, reflects the difficulty in preparing the regulations. Specifically it found

--no organized files of FNMA correspondence,

--no collection of FNMA documents or departmental memoranda on FNMA issues,

--no career HUD personnel experienced in administrating the regulatory relationship between HUD and FNMA, and

--minimal past supervision of FNMA by HUD exercised on an informal basis.

Among other things the revised regulations

--codified the statutory approval functions concerning the operations of FNMA the Charter Act had vested in HUD,

--allowed HUD to establish an annual goal for conventional mortgage purchases related to housing for low- and moderate-income families,

--required FNMA to submit regular reports to HUD on various market activities, and

--authorized annual audits of FNMA's books and financial transactions. However, the Secretary could choose to accept FNMA's independent auditor's report in meeting the audit requirement.

Shortly after the revised regulations were issued, HUD established a FNMA oversight unit within its Office of the General Counsel. This unit was disbanded in 1982 because there was no clear direction as to which activities HUD should regulate or how HUD would regulate FNMA. Although the oversight unit was disbanded, oversight responsibility remains in the Office of General Counsel.

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[3]The Chairman's statement originally appeared in "Secondary Market Operations of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation," Hearings before the Committee on Banking, Housing, and Urban Affairs, 94th Congress, Second Session, December 9, 1976.

The preamble to the 1978 revised regulations also criticized FNMA for not meeting its public-purpose responsibilities. For example, HUD stated in the preamble that FNMA had

--failed to accomplish the public purpose of the Charter Act because it has not adequately encouraged and assisted sound urban lending,

--failed to assume any responsibility to direct its growing conventional mortgage purchases to the needs of low- and moderate-income families,

--followed pricing procedures that contributed to increases in mortgage interest rates, and

--maintained a mortgage portfolio larger than necessary.

HUD uncertain over its regulatory role

HUD officials told us they are not sure what HUD's oversight and regulatory role should be. They believe the public sector regulation of a private-sector corporation as laid out in the Charter Act was inconsistent. Furthermore, the officials believe that the type of regulatory structure envisioned is not needed in the presence of a board of directors and that major questions must be dealt with in determining the roles of HUD in terms of oversight and regulation. For example, HUD officials told us they still had no clear sense of

--what regulations were needed to ensure the achievement of the Charter Act's purposes,

--what specific FNMA activites HUD should regulate, and

--whether HUD should develop the capability and expertise to be a "watchdog" over FNMA, as the FHLBB is to an extent over savings and loan associations.

HUD's uncertainty over how to regulate FNMA is not new. For example, in a letter dated December 9, 1976, to the Chairman, Committee on Banking, Housing, and Urban Affairs, the Secretary of HUD stated:

"It is a fair observation that neither the statute nor its legislative history gives substantial guidance as to the precise way in which HUD is to carry out its regulatory functions in regard to FNMA. However, the legislative history does indicate congressional intent that these functions should be exercised conservatively in general and, in any event, more rigorously during the FNMA transition from public agency to private entity than thereafter. This would seem an appropriate time

for the Congress to examine HUD's regulatory approach and the procedures currently in use which implement that approach in order to determine if a redefinition of its intent would be in order. . . . Such an examination of HUD's policy regarding the regulation of FNMA and, if deemed necessary, of clearer definition of congressional intent in regard thereto, would not only be useful to HUD but would also be beneficial to FNMA, the FNMA shareholders, Congress, and the public."[4]

HUD officials believe the agency has neither the capacity nor the expertise to perform certain of the roles suggested by the Charter Act. HUD has, therefore, not performed financial audits or the FNMA study that were contemplated in the Charter Act. HUD through its Office of Inspector General (OIG) has on occasion reviewed FNMA activities as they relate to ongoing HUD programs. For example, the OIG reviewed the GNMA combined-services agreement with FNMA regarding GNMA mortgage-backed securities. However, according to OIG representatives the audits are not directed toward evaluating FNMA performance in meeting the objectives of the Charter Act or reviewing its overall financial performance.

Additionally, HUD has essentially abrogated its enforcement of the regulatory requirement allowing it to establish a numerical goal for FNMA's conventional loan purchases representing housing for low- and moderate-income families. FNMA purchases constituted one of the benefits envisioned by the Charter Act. To show that it was meeting the 30-percent criterion, HUD required FNMA to submit a report to it. FNMA began requiring data from its sellers as of July 1, 1979, so that it could provide that report to HUD. On August 6, 1982, FNMA requested that it no longer be required to collect certain data from mortgage sellers or to submit quarterly reports on FNMA's mortgage purchases, including data and reports on loan purchases involving low- and moderate-income families. The request letter stated that this change would eliminate significant reporting and recordkeeping burdens for FNMA and its sellers and servicers. HUD's response stated that the data were not used by the Department; and, therefore, it approved the request to delete its collection and reporting. A HUD official told us that the regulations' definition of low- and moderate-income is outdated and of limited use.

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[4]Letter of Secretary Carla A. Hills to Chairman William Proxmire of December 9, 1976, quoted in hearings on FNMA and FHLMC secondary market operations, 94th Congress, Second Session (1976), pp. 634-635.

HUD's limited oversight is also suggested by its response to our request for detailed information on FNMA, which would enable us to assess the (1) impact of FNMA programs on low- and moderate-income households, (2) interest rate and credit risk of FNMA programs, and (3) credit risk associated with defaults and foreclosures on FNMA-purchased mortgages. To determine the impact of FNMA purchases on low- and moderate-income families, we requested data on individual mortgage purchases (mortgagee's income, for example). To determine interest rate and credit risk, we requested loan maturity data by loan type (FHA, VA, conventional) and mortgage type (ARM, GPARM, second, buy-down, fixed-rate). For default and foreclosure data, we asked HUD for various time series data, such as the number and value of loans that FNMA has asked loan originators to repurchase and the number of homes owned by FNMA.

The information we requested would have been necessary to assess FNMA's risks and whether the firm is carrying out certain of its legislated responsibilities.[5] The information is not otherwise publicly available. HUD supplied some but not all of the information we requested. The data not supplied by HUD were data HUD did not collect. Other data that related to the impact of FNMA programs on low- and moderate-income households had been collected by HUD at one time, but that collection was discontinued in 1982 because HUD did not use the data.

HUD's review of proposed FNMA programs

HUD's regulations require it to approve FNMA's new program requests. HUD officials told us that it has no formalized procedure for reviewing FNMA program requests. Generally HUD's Office of the General Counsel carries out this approval process by

--evaluating FNMA-written requests to determine if the program meets the public purpose and authority of the Charter Act;

--obtaining comments from various operating groups within HUD, such as those dealing with housing finance and the housing market;

--requesting additional information from FNMA, if necessary, regarding ongoing as well as proposed programs; and

--obtaining public comments concerning proposed programs.

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[5]We had previously requested similar information from FNMA. We did not have access to individual foreclosures or to FNMA's analysis of its foreclosure experience. We do not have statutory right of access to FNMA records (see chapter 1).

As we determined from information supplied by FNMA and HUD, FNMA has requested review and/or approval of ten programs from March 1977 to February 1983. Given the broad focus of our review and our time constraints, we were unable to review in detail the quality of the FNMA submissions or the timeliness of HUD's reviews of proposed programs.

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Chapter 7 of this report summarizes our findings on HUD oversight activities and relates them to the public-policy questions arising from FNMA operations and the changing economic environment.

TREASURY's OVERSIGHT ROLE

As shown in figure 6.4 on page 97, the Charter Act gave specific powers to the Secretary of Treasury. These powers include

--approving type, amounts, maturities, and interest rates of FNMA's proposed borrowing (general obligations, mortgage-backed securities, and subordinate obligations) and

--the discretion to purchase FNMA general obligations up to $2.25 billion.

The first power enables Treasury to coordinate FNMA borrowing with other federal borrowing in the credit markets.[6] The second power provides for "backstop borrowing."

Treasury control over FNMA debt issuances

Treasury controls FNMA debt through approval of new issuances of FNMA's debt securities. The Treasury issues a regular calendar schedule that sets a specific time each month that FNMA can issue its longer-term debentures. In addition, FNMA can borrow "off-calendar" with Treasury approval as long as it does not interfere with Treasury or other "agency" borrowers. According to FNMA, HUD, and Treasury officials, a mutually agreeable calendar schedule has been established, and off-calendar borrowings are generally routine. However, FNMA officials also indicated that the Treasury approval of new forms of financing is not routine. For

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[6]The Charter Act gave HUD approval over FNMA's issuance of stock, obligations, securities, or other instruments. This power was deferred to the Secretary of Treasury by HUD regulation. The Secondary Mortgage Market Enhancement Act (Public Law 98-440) ends HUD's approval authority for debt obligations, effective October 1, 1985, but retains HUD approval authority over issuance of stock and debt convertible to stock.

example, under Treasury regulations, FNMA cannot issue debt overseas in bearer form or with certain other provisions that would enhance investor reception. FNMA believes that tapping the overseas market by issuing debt in bearer form would result in lower borrowing costs. In its comments on this report, FNMA added that on occasion delays by Treasury have resulted in higher debt costs.

Treasury back-stop authority

The Charter Act provides FNMA with a direct link to the U.S. Treasury. Section 304(c) of the 1968 Charter Act amendments authorizes Treasury to purchase FNMA obligations up to $2.25 billion outstanding at any one time. Approval of such borrowing authority is at Treasury's discretion. FNMA has not used this borrowing authority since its transformation into a private corporation in 1968.

RECENT LEGISLATIVE ACTIONS HAVE REDUCED HUD's STATUTORY ROLE

Recent legislative changes that affect HUD regulation of FNMA as contained in the Secondary Mortgage Market Enhancement Act of 1984 include

--removing HUD's approval authority, after September 30, 1985, on FNMA's new debt obligations, except for debt convertible to stock;

--authorizing FNMA to purchase and deal in subordinate lien mortgages without further specific regulatory approval until (1) October 1, 1987, for mortgages against a one- to four-family residence and (2) October 1, 1985, for mortgages against a property comprised of five or more family dwelling units;

--requiring HUD to report to Congress on FNMA's activities not later than June 30 of each year;

--increasing FNMA's Board of Directors to 18 persons, 5 of whom shall be appointed by the President of the United States; and

--requiring HUD to approve a FNMA request within 45 days or transmit a report to Congress explaining why it has not been approved. An extension of 15 days is permitted, but, if a report is not transmitted to Congress in the 45- or 60-day period, FNMA may proceed as if the request had been approved.

During congressional debate, comments from both houses indicated that the primary purpose of the Enhancement Act was to increase the efficiency of the housing finance system. This included easing the entry of private firms into the secondary mortgage market, thereby making it possible for more families to own homes.

One senator indicated the importance of congressional and departmental oversight of quasi-governmental agencies. He hoped

> ". . . that between enactment of this legislation and October 1, 1985, both the House and Senate Banking Committees will be adequately advised by the administration, [FNMA], and GAO as to which department reviews, which type of issuance and for what purpose, so that the Congress can determine what the appropriate oversight role is for HUD and the Treasury Department."

In the House, one representative's comments seem to indicate less oversight is needed:

> ". . . While the committee has agreed to continue the authority of the HUD Secretary to approve FNMA's issuance of obligations to other instruments until September 30, 1985, it wishes to make clear that it does not expect FNMA's requests to meet with any long and unnecessary delays. The committee also does not expect this authority to be used in any way to emphasize or deemphasize certain activities where the HUD direction may not be consistent with congressional intent. And third, the committee expects HUD to keep in mind that FNMA participates in a very competitive market and to not in any way interfere with their response to market developments through the use of obligational authority."

FNMA concurrence with and HUD concern over the legislative amendments

FNMA believes the changes provided by the Enhancement Act will maintain the regulatory balance sought by Congress; they benefit FNMA, the government, and American homebuyers and renters. A FNMA document indicates that further regulatory changes to the Charter Act would be premature at this time because these adjustments to HUD's regulatory authority have yet to be fully tried and tested.

FNMA's concluding statement in a paper prepared for us entitled "The Federal Regulation of Fannie Mae" is:

> "The regulatory changes enacted in the 1984 Secondary Market Enhancement Act reflect the view of Congress that Fannie Mae's basic public purpose--to serve housing--is

best achieved by maintaining a regulatory process that grants Fannie Mae the flexibility to meet changing market demands. Any sudden or premature shift in this regulatory regime would damage the corporation and the purpose it serves."

In discussing the 45-day limitation for HUD's review of FNMA's requests, the paper states that in recent years HUD has, for the most part, respected the balance established by Congress between the government's regulatory role and the business flexibility FNMA needs. However, in several instances, mostly during the late 1970's, certain program innovations were delayed by government interference in FNMA's activities. By mandating specific time constraints for program approvals, Congress designed the 1984 law to preclude the very problems FNMA had experienced in the late 1970's.

HUD, however, has expressed some concern over the amendments. A May 25, 1984, letter from the Secretary of HUD to the Chairman of the House Committee on Banking, Finance, and Urban Affairs prior to the passage of the Secondary Mortgage Market Enhancement Act states that provisions of the act weaken and set a precedent for eliminating the HUD oversight role over the secondary market activities of FNMA. The Secretary stated,

". . . removal of HUD oversight authority over matters pertaining to FNMA's financial structure would come at a time when the necessity for an enhanced oversight of such matters from the programmatic perspectives of HUD is becoming more apparent and urgent. . . . Changes in the market structures within which its activities are conducted require constant monitoring, adaptation, and response, not solely by [FNMA] from the perspective of the interests of its shareholders, but by the Executive agency created by Congress to exercise leadership and establish coherence in federal activities affecting housing."

Furthermore, the Secretary acknowledged the needs of FNMA to obtain prompt attention and response to its requests, but he could not agree that an annual report by HUD to Congress is an adequate substitute for active and continuing HUD oversight.

FNMA AND HUD COMMENTS ON REGULATION AND OVERSIGHT

FNMA comments

FNMA said that our recommendations, if improperly interpreted, could be used to argue for limiting the corporation's management flexibility. It acknowledged the need for FNMA oversight but suggested that HUD regulation should be performance oriented with

the corporation periodically reviewed against public policy objectives. FNMA also said that providing us audit authority was inconsistent with the corporation's private business identity.

GAO response

We did not suggest a particular federal role and certainly not one that would limit the corporation's ability to manage. One appropriate role might be analagous to that of regulators of other financial institutions. Thrift institutions are free to manage within broad parameters to produce a profit, yet the riskiness of their loan portfolios is monitored in terms of both credit and interest rate risk. If necessary, financial regulators can require a thrift institution to modify its business activity to mitigate risk.

Our recommendation on audit authority is consistent with our long standing position that, except for entities we are required to audit by law, government sponsored or chartered corporations should be audited by independent private accountants, but that we can review these audits and should have authority to access records and perform audits and evaluations of these corporations.

HUD comments

Although HUD did not comment on this report in writing, senior agency officials met with us and provided official oral comments. Their remarks were generally confined to the area of regulation and oversight. The Department said that since 1968 when HUD was given authority to oversee and regulate FNMA, many changes have taken place in the secondary mortgage market, in FNMA's size and programs, and in FNMA's role in the secondary mortgage market. The officials said our report indicates that these changes have diminished some of the public-purpose benefits FNMA was chartered to provide, while enhancing the value of FNMA's "agency status."

At the same time, certain of the same changes--particularly in FNMA's size and in the volatility and range of interest rate cycles--have resulted in FNMA's operations entailing risks of a magnitude that the Congress could not have foreseen in 1968. In view of all of these changes, HUD agrees that it may be time for Congress to reevaluate the purpose and focus of the federal oversight over FNMA that it wishes to be exercised and, following that definition, the institutional means of carrying it out.

HUD believes that its oversight function was not intended to be merely duplicative of the role of other institutions. For example, it has believed that Congress did not intend HUD to invade the area of "business judgment"--including the correction of misjudgments--that is reserved to FNMA's Board of Directors. Similarly, HUD does not believe that it should attempt to perform a financial watchdog role that is essentially the role of FNMA's

outside auditors (i.e., to ensure fair representation and disclosure of FNMA's financial condition--including nature and degree of risk assumed and adequacy of provision therefore--and results of operation). (A third source of "oversight" that is critical in the case of most corporations is the analytical assessment by investors and market analysts based on disclosure pursuant to SEC requirements. FNMA's exemption from these requirements may affect the approach to FNMA disclosure by FNMA itself, its directors, underwriters and auditors, as well as by outside analysts. HUD doubts that there is justification for continuation of FNMA's broad exemption from SEC disclosure requirements and liability coverage.) Accordingly, HUD has conceived its principal role as ensuring that FNMA's activities are designed and carried out in a manner intended to further Charter Act purposes. HUD believes that its principal means of performing this role is through its approval of FNMA programs (a role which Congress has chosen recently to reduce). A further means of performing this role will be through the new annual reporting requirements.

HUD believes that with relatively minor internal redefinitions of functions and organizational structure, it has sufficient capacity to perform the policy-perspective oversight role described above. A broader "watchdog" role, which would essentially be similar to the role of the financial regulatory agencies in relation to regulated financial institutions, is a far different role that is probably beyond HUD's capacity. Again, HUD believes that Congress did not envision such a role being performed by anyone in relation to FNMA because it did not contemplate that FNMA's operations would entail risk to this magnitude. (Section 303(b) of the Charter Act expresses the expectation that FNMA's operations would be "self-supporting.")

While HUD believes that a policy-perspective oversight role such as that described above is important, HUD notes that Congress' most recent actions have been in the direction of diminishing, rather than strengthening, this role. In the Secondary Mortgage Market Enhancement Act of 1984, Congress removed HUD's approval authority relative to FNMA's debt structure (effective October 1, 1985) and established FNMA program authority that is not subject to HUD approval authority. These actions were taken notwithstanding strong objections by the HUD Secretary based on their impact on HUD's oversight role.

GAO response

We generally agree with HUD's comments but note the following:

--HUD's evaluation efforts relative to FNMA's public purpose should not be confined to studying new FNMA programs, but should include a periodic look at all FNMA activities in terms of its contribution to public policy objectives.

--Although HUD concludes that it probably does not have the capacity to act as a financial regulator or "watchdog" in evaluating FNMA's risks, this is nonetheless an important function. If HUD does not have, or cannot develop, this capability, it could contract with another financial regulatory agency to perform this function.

--Improved oversight evaluation and regulation as suggested by us would aid any congressional re-examination of FNMA's role.

CHAPTER 7

SUMMARY AND RECOMMENDATIONS TO THE CONGRESS

FNMA owns a large portfolio of mortgage loans, many of which carry interest rates well below those that FNMA is now required to pay in order to borrow in today's market. Much of its debt must be continually refinanced (over $31 billion in 1985), while the mortgages in its portfolio will not pay off for many years. This mismatch has resulted in large interest losses in recent years. To offset these losses FNMA must, therefore, generate substantial income by making new mortgage purchases at rates higher than those at which it borrows and by collecting fees from lenders and investors when it (1) purchases new mortgages or (2) guarantees securities backed by mortgages that it sells.

When interest rates increased rapidly to historic highs in 1980, FNMA employed this strategy of obtaining new mortgages to offset huge losses on its existing portfolio. As a result the size of its portfolio grew from $57 billion in 1980 to $88 billion at the end of 1984. Although it has taken other steps to reduce both its interest rate risk and the likelihood of a future financial crisis, FNMA's portfolio growth increases the potential losses it would suffer should interest rates increase substantially just as it increases profit potential should they fall.

If FNMA were a strictly private firm with no federal government connections and with a less prominent place in the financial markets, its potential future losses would be of much less public interest. However, the corporation is one of the largest financial institutions in the United States. It also enjoys significant financial advantages from its federal charter. A perception exists in the credit markets that the federal government would not let a FNMA insolvency affect FNMA debt holders because of possible financial losses on the savings and loans, commercial banks, and other institutions that hold its debt. It is in this context that a variety of questions regarding FNMA and its operations takes on public policy significance.

CHANGES IN THE MORTGAGE LENDING INDUSTRY

The housing finance system is a complex array of financial institutions, using instruments with varying degrees of risk, maturity, and marketability. This system has evolved over the past one-half century to assist buyers of houses in financing their purchases. It is the result of a series of federal policies and laws establishing and regulating public and private lending institutions, mortgage insurance, and other services.

High and volatile interest rates in the late 1970's and early 1980's created a financial crisis for savings and loans, FNMA, and other portfolio lenders. Though earlier legislation and regulation insulated mortgage finance from broader credit markets, changes beginning in 1978 have eliminated many of those provisions and integrated the mortgage markets with the credit markets. A variety of deregulatory moves and innovations in the primary mortgage markets has increased competition and enabled the thrifts to better adjust to market conditions. These changes have also altered FNMA's activities in the secondary market.

PROFITABILITY IS RELATED TO INTEREST RATE RISK

After 12 profitable years, FNMA reported losses in 1981 and 1982 and again in 1984. The primary determinant of FNMA's profits and losses was its interest margin--the difference between the interest FNMA earns on its mortgages and other assets and the interest FNMA pays on the money it borrows. However, in the 1981-1984 period such factors as fee income, gains on the sale of mortgages, provisions for foreclosure losses, and administrative expenses were also significant determinants of FNMA's total profits or losses.

Two initiatives FNMA undertook in 1981 have been successful in producing earnings to partially offset the negative interest margins experienced in 1981-1984. These were (1) increasing fee income and (2) earning money from the positive interest margin on the large volume of mortgages purchased in 1981 and later years.

These same measures have also greatly increased the size of its portfolio. While these measures have improved profitability and may have reduced the likelihood of federal intervention being needed, they may also have increased the magnitude of the financial assistance the financial community expects the federal government would provide FNMA should it encounter serious financial difficulties. Such difficulty could occur if interest rates rise and remain at higher levels for an extended period, causing large annual losses for FNMA because of the increased negative interest margin. We were unable, however, to obtain the detailed portfolio information necessary to analyze the sensitivity of FNMA's financial position to changes in future interest rates.

CREDIT RISK

Recent economic conditions and certain FNMA decisions have probably increased its credit (or foreclosure) risk and have caused substantial losses for the first time in FNMA's history. Foreclosure losses for 1984 were $87.3 million. Total foreclosure volume was actually much greater, but mortgage insurers reimbursed FNMA for nearly $600 million in 1984. This foreclosure loss was up from $38.4 million in 1983 and $1.6 million in 1982. Foreclosures on FMNA loans have increased from 0.13 percent of total

portfolio in 1981 to 0.86 percent in 1984, an increase similar to the recession in the mid-1970's. Comparison of FNMA foreclosure rates to those of other large mortgage holders shows this increase may exceed the other lenders'.

FNMA probably increased its exposure to losses from foreclosures in 1981 and 1982 when it added to its portfolio a large volume of loans carrying higher interest rates. This had the intended effect of adding to income because FNMA earns higher mortgage yields and collects up-front fees on mortgages it purchases. FNMA's increased exposure to foreclosure losses was very likely due to a combination of factors including the following:

--changes in FNMA's business practices and underwriting standards allowing borrowers to acquire increased debt as a percent of income;

--property value stagnation resulting from historic high interest rates, slowed economic growth, and reduced inflation; and

--the riskier nature of some loans written during the 1980-1981 recession that were structured with graduated payments that increase rapidly during the first few years after origination, regardless of the movement in interest rates.

Knowledgeable industry experts substantiated the likely roles of these factors in FNMA losses. But we did not have direct access to FNMA's detailed delinquency or foreclosure data and were forced to rely on FNMA's statements, outside sources, and summary statistics to reach tentative judgments. As a result of these losses, FNMA has taken steps to reduce its potential foreclosure losses in the future, but the success of these steps cannot be predicted.

FNMA BENEFITS TO HOUSING AND MORTGAGE FINANCE AND FEDERAL SUPPORTS

Although individuals, investors, and institutions have always purchased mortgages for investment portfolios, the growth of a national secondary mortgage market began with the creation of FNMA. In cooperation with FHA, which insured mortgages providing additional security to investors, FNMA developed standard mortgage instruments and created a national secondary market in residential loans. The market has, over the years, been augmented by the addition of other credit agencies such as GNMA and the entry of private firms that have begun to sell securities backed by mortgages.

Financial advantages

Congress created FNMA to perform this market-building role and provided it with a variety of supports for assistance including

--Treasury authority to purchase FNMA securities under terms it would prescribe should this ever be necessary;

--exemption from state and local income taxes and SEC registration fees; and

--the ability of regulated financial institutions, such as banks and pension funds, to hold FNMA debt instruments interchangably with Treasury's securities.

In turn, FNMA's secondary market activity is limited to residential mortgages with principal amounts that do not exceed limits established by Congress (currently set at $115,300). These advantages have saved FNMA millions of dollars in fees and state and local taxes; but more importantly, they create the impression that FNMA is an agency of the federal government. This perception allows FNMA to receive the highest quality rating possible for a private firm for its debt and to borrow in the credit markets at interest rates close to those of the U.S. Treasury. Without this advantage, FNMA debt costs would reflect a lower credit rating much closer to the underlying security of its debt--namely mortgages that are considered to be medium-grade securities. This would mean that even under other favorable assumptions about its financial condition, FNMA could be expected to pay substantially higher debt costs without "agency status." For example, in 1983, FNMA's most recent profitable year, a one half of a percentage point increase in its average borrowing costs would have resulted in increased interest expenses of $157 million which even after tax considerations would have offset its $75 million in profits. In essence, and FNMA agrees with this conclusion, it could not continue to operate with its present mortgage portfolio without this implicit "agency status."

As FNMA's mortgage portfolio has grown, the aggregate value of these financial advantages has increased, and recent changes in the tax treatment of its losses and modest relaxations of restrictions on its assets (for example FNMA can now buy second mortgages) have added to the firm's profit potential. But the benefits that FNMA has provided have changed while many of the original benefits it provided have declined.

Societal and economic benefits

FNMA's charter defined it role as providing ". . . supplemental assistance to the secondary market to home mortgages by providing a degree of liquidity for mortgage investments, thereby

improving the distribution of investment capital available for home mortgage financing." The purpose was to help establish a secondary market for mortgages. This supplementary assistance function has been interpreted by FNMA and others to encompass a variety of activities.

Such activities include redistributing credit geographically, tapping non-traditional sources of funds, and providing mortgage funds when other lenders withdraw from the market during credit crunches. The Charter Act and HUD regulations also require that a reasonable portion of FNMA mortgage purchases assist low- and moderate-income households but with reasonable economic return to the corporation.

FNMA performed its supplemental assistance and market-building function by

--serving as a national supplier of mortgage funds;

--providing an outlet for loans from federal mortgage programs and housing subsidy programs;

--providing funds to the mortgage markets during periods of scarce credit; and,

--along with other credit agencies, lowering the cost and increasing the supply of mortgage credit.

But conditions changed: the primary and secondary mortgage market grew, the thrift industry was deregulated, and other federal credit agencies such as GNMA became active in the secondary mortgage market. With these changes, certain of the significant benefits that FNMA provided in the 1970's appear to have declined while FNMA has responded to new market demands.

--FNMA was originally the only truly national buyer of home mortgages and helped channel funds to geographic areas experiencing credit shortages through its purchase of FHA and VA mortgages.

--For example, through the mid-1970's FNMA was the principal buyer of FHA/VA single-family and FHA multifamily project loans. A variety of factors has shifted FNMA's new business largely to conventional single-family loans for middle-income households. Government subsidy programs utilizing FHA rental housing loans were phased out, and, until recently, FNMA could not purchase conventional multifamily rental housing mortgages. In addition, FNMA began guaranteeing FHA/VA lower-cost source of funds for these loans, while FNMA moved into the conventional mortgage market in 1972. As a result, conventional loans began to dominate FNMA purchases in 1976 and amounted to nearly 99 percent of its purchases in 1983.

--Earlier credit cycles, and the resulting decrease in deposits at thrift institutions, caused by limits on what they could pay depositors, created a natural counter-cyclical role for FNMA. It could still borrow and therefore absorb mortgage lending business lost by savings and loans and other depositors. Deregulation and the integration of housing finance into the credit markets have probably reduced this role. In the last housing downturn, when thrifts were still limited to some extent by interest rate ceilings, FNMA's activity did not appear to be counter-cyclical. Rather, its loan activity seemed to follow the trends in thrift deposits and did not increase as housing starts declined or decrease as mortgage lending in general rebounded. FNMA contends that its role has changed from one of improving the supply of credit prior to 1980, to one of decreasing the cost of credit during downturns in housing. Based upon the information provided by FNMA, we were unable to verify this contention. FNMA also notes that it taps a broader investor base than other secondary market participants because it can issue short and intermediate term debt that is attractive to investors who would not invest in mortgages or mortgage-backed securities.

HUD HAS NOT FULLY EXERCISED ITS OVERSIGHT ROLE; TREASURY's ROLE ROUTINE

In setting up FNMA as a private corporation, Congress recognized that safeguards, in terms of HUD and Treasury oversight, were needed to ensure that FNMA would carry out its public functions and use its borrowing powers in a responsible way.

HUD oversight and regulation

Under FNMA's charter, HUD is empowered to issue rules and regulations to ensure that the act's purposes are accomplished, review FNMA's financial operations, and prepare studies on the extent to which FNMA meets the purposes of the act. Certain of these regulatory powers must be exercised consistent with maintaining a reasonable economic return to FNMA and its stockholders. Also, HUD regulation may not extend to "usual" corporate matters, such as setting salaries. For the most part, the act gave considerable discretion in the extent to which it regulates and oversees FNMA. HUD has carried out some of its oversight activities, such as issuing regulations and reviewing FNMA requests to undertake new programs. Within the limits of our review, we identified several areas in which HUD's oversight performance has fallen short of what we believe Congress envisioned in the charter:

--The Charter Act called for HUD oversight of FNMA operations. While HUD established a FNMA oversight unit within its Office of General Counsel shortly after issuing its

1978 revised regulations, the unit was disbanded in 1982. Presently HUD has no staff dedicated exclusively to FNMA oversight.

--Although HUD has audit authority and access to FNMA records, it has chosen not to utilize its audit authority in favor of FNMA's independent financial auditors. This may be consistent with the private, but not necessarily the public-purpose, side of FNMA's identity. HUD has not directly accessed FNMA's files and records and, therefore, data on certain aspects of FNMA operations, having public policy implications, are not available to the government or the Congress.

--HUD has not analyzed the financial risk to which FNMA exposes the government or evaluated alternative risk management strategies which FNMA might pursue.

--More generally HUD has not undertaken a study of how well FNMA still serves its public-purpose role. For example it has not recently attempted to determine whether a reasonable portion of FNMA's purchases benefit low- and moderate-income households and no longer requires FNMA to submit the information necessary to do so.

--HUD has not submitted a report on FNMA activities required by Congress since 1978. Recent legislation dropped this requirement in favor of an annual report but HUD says it is now preparing the originally required report voluntarily.

HUD officials responsible for oversight and regulation are unsure of the nature of their role. They believe the public-sector regulation of a private-sector corporation as laid out in the charter was inconsistent. HUD officials told us that they have no clear sense of what regulations are needed to ensure that charter purposes are achieved, the specific FNMA activities HUD should regulate, or whether HUD should or could develop the capability and expertise to be a "watchdog" over FNMA's risk management activities. Finally, HUD officials do not believe the Department presently has the capacity or expertise to perform certain functions which might be expected of a financial institution regulator such as monitoring FNMA's interest rate risk.

We believe that the relationship between FNMA and the government is quite different than that of other regulated industries. FNMA's ties to the government oversight should extend to evaluating the reasonableness of the risk FNMA is taking and the degree to which it is achieving public purposes.

Treasury oversight

Treasury controls FNMA debt through approval of new issuances of FNMA's debt securities. The Treasury issues a regular calendar schedule that sets a specific time each month that FNMA can issue its longer-term debentures. In addition, FNMA can borrow "off-calendar" with Treasury approval as long as it does not interfere with Treasury or other "agency" borrowers. According to FNMA, HUD, and Treasury officials, a mutually agreeable calendar schedule has been established, and approvals of off-calendar borrowing are generally routine. A noteable exception was Treasury disapproval of FNMA's request to issue bearer debt in offshore markets.

RECOMMENDATIONS TO THE CONGRESS

FNMA's multiple links to the federal government expose the government to a potentially large but ill-defined financial risk. This arrangement was created on the premise that FNMA's operations would achieve public policy objectives.

We could not fully explore every aspect of HUD's regulatory and oversight performance in the time available. We believe, however, that the Department's performance has fallen short of what Congress envisioned in the Charter Act. Furthermore, FNMA's significant growth, its losses in recent years, and the level of risk which it must now take to continue operating were probably not anticipated in 1968. As a result, Congress may not always have had adequate information regarding FNMA's activities, and certain important regulatory and oversight functions may not have been performed, during a period when economic and legislative changes have buffeted the home lending business.

To improve the regulatory, oversight, and evaluation functions relative to FNMA, we recommend that Congress

- --establish by legislation a permanent oversight function within HUD or some other federal regulatory entity that will monitor FNMA activities, evaluate how well it performs its public policy objectives, and periodically report to the Congress on these matters; and

- --clarify in legislation the regulatory role desired by Congress, particularly as regards aspects of FNMA's operations such as its portfolio operations which expose the federal government to financial risk.

In carrying out this review, we did not have legal access to all the information needed and had to rely on information provided voluntarily by FNMA. We, therefore, recommend that Congress provide us with the authority to audit FNMA's financial records and

evaluate its programs and with the right to access all FNMA corporate records. This would allow us to be more responsive to the needs of Congress.

AGENCY COMMENTS ON GAO RECOMMENDATIONS

FNMA comments

FNMA said that our recommendations, if improperly interpreted, could be used to argue for limiting the corporation's management flexibility. It acknowledged the need for FNMA oversight but suggested that HUD regulation should be performance oriented with the corporation periodically reviewed against public policy objectives. FNMA also said that providing us audit authority was inconsistent with the corporation's private business identity.

GAO response

As regards regulation and oversight, we did not suggest any particular federal role and certainly not one that would limit the corporation's ability to manage. For example, one appropriate role might be analagous to that of regulators of other financial institutions. Thrift institutions are free to manage within broad parameters to produce a profit, yet the riskiness of their loan portfolios is monitored in terms of both credit and interest rate risk. If necessary, financial regulators can require a thrift institution to modify its business activity to mitigate risk.

Our recommendation on audit authority is consistent with our longstanding position that, except for entities GAO is required to audit by law, government-sponsored or chartered corporations should be audited by independent private accountants. We also believe that we should be able to review these audits and should have authority to access records and perform audits and evaluations of these corporations.

HUD comments

HUD said that our report would be useful to the Department in completing its report on FNMA, and made three major points:

--HUD has concentrated on program approvals and their public implications, and has structured its oversight role to avoid duplicating the efforts of others, such as FNMA's independent auditors and the Treasury. The Department noted that some overlaps, such as exists between the FHLBB's supervisory responsibilities over thrifts and those of the thrifts' internal auditors may be necessary.

--Given changes in the size and nature of FNMA's activities, it may be time to reconsider the government's regulation and oversight of FNMA as we suggest. In particular,

Congress probably did not envision the risk to which FNMA now exposes the government, although monitoring this risk may be beyond HUD's capacity.

--Despite HUD objections, Congress recently weakened its regulatory control over FNMA by voting to remove HUD approval of its debt and certain mortgage purchase programs.

HUD concludes that our report indirectly raises a deeper question which is probably beyond the scope of this study, but should be a primary focus of congressional reexamination. The magnitude of the risk inherent in FNMA's current portfolio is itself the result of the advantages conferred upon FNMA by Congress. Only the continued access to credit markets resulting from its "agency status" has made it possible. The Department said that our report indicates that the public benefits derived from FNMA's activities have diminished because other evolutionary changes in the secondary market have made FNMA's contributions less unique and indispensable. The Department raised the question of whether there is a continuing public benefit from FNMA's operations that is adequate to justify the continuation of the unique advantages it enjoys for a single institution. If the answer is negative, then HUD said a further question must be addressed, which is how a FNMA withdrawal from its risk-entailing activity--its massive portfolio investment activity--can be arranged in a manner fair to its stockholders and debt security holders. Given this current situation the Department thought that our focus on oversight may be appropriate; but it also thought that this focus accepts the continuation of those activities and, in essence, avoids the more fundamental question.

GAO response

We agree in general with HUD's comments, including the observation that our work raises the basic question of whether Congress should reconsider FNMA's public purpose role. We believe the information in this report provides a base on which the Congress could build if it were to do so.

Given the change in the economic environment within which FNMA operates and the growth in its size, we believe that HUD's role must extend beyond a focus on program approvals, to include monitoring financial risk and periodically evaluating the corporation's contributions to the mortgage and housing markets:

--HUD's evaluation efforts relative to FNMA's public purpose should not be confined to studying new FNMA programs, but should include a periodic look at all FNMA activities in terms of its contribution to public policy objectives.

--Although HUD concludes that it probably does not have the capacity to act as a financial regulator or "watchdog" in evaluating FNMA's risks, this is nonetheless an important function. If HUD does not have or cannot develop this capability, it could contract with another financial regulatory agency to perform this function.

--Improved oversight, evaluation, and regulation as suggested by us would aid any congressional re-examination of FNMA's role.

APPENDIX I

JAKE GARN, UTAH, CHAIRMAN

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United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

WASHINGTON, D.C. 20510

Mr. Charles A. Bowsher, Comptroller General
General Accounting Office
441 G Street, N.w.
Washington, D.C. 20548

Dear Mr. Bowsher:

This letter requests a report by the General Accounting Office on the current financial operations and future financial environment faced by the Federal National Mortgage Association (Fannie Mae).

Fannie Mae has successfully reversed a period of losses attributed to the effect of unusually high interest rates on its large portfolio of long-term assets financed with shorter term liabilities. Looking to the future though, there are significant issues and questions about an appropriate strategy to solve this asset-liability mismatch without unduly relying on the explicit and implicit government guarantee of Fannie Mae. Furthermore with the likelihood that the Federal Home Loan Mortgage Corporation will become taxed, there is more active consideration of converting this companion federal corporation to more private status.

This Committee expressed concern over the financial condition of Fannie Mae in November 1983 (see Committee Report 98-293 accompanying S.2040), and required the Secretary of Housing and Urban Development "to complete and deliver to Congress, at the earliest practicable data, the review of the financial operations of Fannie Mae" as required by legislation in 1977. That report has never been completed.

Given these circumstances, the rapidly changing nature of the secondary mortgage market, the growth of Fannie Mae operations, and the impact of Fannie Mae in the U.S. credit markets, we believe it is essential that the Congress have a thorough and independent review of Fannie Mae in as expeditious a manner as possible. Consequently we are requesting that the General Accounting Office evaluate and report on the following:

1. A review of Fannie Mae's operating programs and activities in relation to the purpose stated in Section 301 of their Charter Act - to provide supplementary assistance to the secondary mortgage market. This would include any recommendations about programs which could be provided competetively by fully private organizations such as activities that may constitute or come close to direct lending.

APPENDIX I

2. A review and assessment of potential strategies to reduce the mismatch between assets and liabilities, and the possible risks to the government of those strategies in light of the explicit and implicit government guarantees. This assessment should examine the effect of differing economic scenarios and assumptions on alternate business strategies.

3. A review of salary and compensation benefits, overhead and administration, outside consulting contracts and fees, and other non-interest operating costs in comparision to other quasi-government organizations and, where appropriate, recommendations for reducing operating expenses.

4. The extent to which explicit and implicit Federal guarantees and other statutory benefits give Fannie Mae an unfair competitive advantage over private sector firms and the extent to which that advantage impedes the development of private sector alternatives to Fannie Mae.

5. The extent to which Fannie Mae has assumed and plans to assume a degree of risk in its operations that would not be possible on the part of a private sector firm operating without Federal assistance.

6. The feasibility of adopting a system whereby Fannie Mae would compensate the Federal government for all of the benefits it receives as a Federally sponsored corporation.

7. Any other information and recommendations you believe appropriate to this Committee's oversight responsibilities.

Please complete this report before January 1, 1985 for the Committee's use in considering any appropriate legislative actions.

Sincerely,

William Proxmire
Ranking Minority Member

Jake Garn
Chairman

APPENDIX I

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United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, D.C. 20510

June 14, 1984

Mr. Charles A. Bowsher, Comptroller General
General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Bowsher:

Pursuant to our request of May 25, 1984, for a GAO study of the Federal National Mortgage Association, we attach a letter dated June 14, 1984, from Senator Chris Dodd.

We would appreciate your reviewing Senator Dodd's concerns and taking them in account as you formulate your report.

Thank you for your further consideration of this important request.

Sincerely,

William Proxmire

Jake Garn

APPENDIX I

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United States Senate

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, D.C. 20510

June 14, 1984

The Honorable Christopher J. Dodd
United States Senate
Washington, D.C. 20510

Dear Chris:

Thank you for your letter of June 8, 1984, regarding the Committee's request of a report from the General Accounting Office on the current and future operations of the Federal National Mortgage Association (Fannie Mae).

Your comments are greatly appreciated and both Senator Proxmire and I concur that the report should be prefaced with GAO's view of the demand and supply of housing capital needs in the future. This will be helpful to the Committee as we continue our review of the secondary mortgage market.

Chris, you made reference to the perception that this letter was "biased" toward a move for "short term privatization" of Fannie Mae. In my view, this report actually focuses on the contrary. It is the intent of this report, as well as the HUD study requested in our Senate Report 98-298, to provide an independent analysis of the operation and financial condition of Fannie Mae. This information will be of critical importance to the Committee in its oversight capacity of reviewing the long term role of Fannie Mae as a provider of supplementary assistance to the secondary market.

We have forwarded a copy of your letter to Comptroller General Bowsher and requested that your concerns be addressed during the formulation of the requested document.

Again, thank you for expressing your concerns.

Sincerely

Jake Garn

Jake Garn

JG/fhd

APPENDIX I

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United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

WASHINGTON, D.C. 20510

June 8, 1984

The Honorable Jake Garn, Chairman
Committee on Banking, Housing and Urban Affairs
Washington, D.C. 20510

Dear Jake;

I have had an opportunity to review the letter that you and Bill Proxmire sent to the General Accounting Office requesting a report on the current financial operations and future financial environment faced by the Federal National Mortgage Association (Fannie Mae).

Despite recent, phenomonal improvements in Fannie Mae's financial picture, I share your concern that the Association's continuing, although lessened, asset-liability mismatch is a serious problem, especially in a climate of escalating interest rates. Further, our Committee will benefit from much of the information requested from the GAO in any possible future consideration of proposals to expand the resources of the secondary mortgage market.

I do have two problems, however, with the tone and scope of the mandate for this GAO report as detailed in your letter of May 25. First, I find that the review of Fannie-Mae lacks a context. There is nothing in the call for this report which asks for an assessment of future mortgage capital needs and the potential of both government sponsored agencies and emerging private participants to respond to the shelter needs of the American people over time.

Second, the requested report seems to seek to make the case for the short-term privatization of the Association. I do not know whether this bias was intended, but I am concerned that we have an historical as well as a market perspective for our deliberations on the future of the secondary mortgage market. For example, in relation to projected need, what can we expect from a private secondary market, when, and under what conditions?

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My concerns here are motivated by the pending fears of escalating interest rates and the importance of government-sponsored mortgage agencies, especially Fannie-Mae, during such periods. Further, the Fannie-Mae Charter Act commits the Association to investment in mortgages in good times and bad. I view this as not only a proper role for government to play, particularly when measured against the rather limited government benefits Fannie-Mae enjoys, but also the most effective means currently available to mitigate the counter-cyclical effects of high interest rates on housing.

My overriding impression is that the future demands for homeownership and mortgage financing will require stronger complementary public and private participants in the secondary market. I would hope that some of my concerns could be included in the GAO's report and I look forward to working with you on this most important issue in the future.

Sincerely

CHRISTOPHER J. DODD
United States Senator

CJD/es

APPENDIX I

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United States Senate

SUBCOMMITTEE ON HOUSING
AND URBAN AFFAIRS
WASHINGTON, D.C. 20510

June 29, 1984

Honorable Charles A. Bowsher
Comptroller General
General Accounting Office
Washington, D.C.

Dear Mr. Bowsher,

We request that the General Accounting Office analyze the Federal National Mortgage Association's (FNMA) capacity to facilitate U.S. mortgage lending and support the nation's need for affordable housing.

Congress has recognized that the continued affordability of housing depends increasingly on a strong, growing secondary mortgage market. Legislation now moving through Congress would both improve the ability of government-sponsored corporations to support the secondary mortgage market and also facilitate the entry of private financial institutions into this market. According to expert testimony, government-sponsored mortgage institutions not only made it possible for a national secondary mortgage market to develop but must continue to provide market stability, which is essential to the sound growth of private sector participation.

Because of FNMA's large role in the secondary mortgage market, we believe that Congress must be able to anticipate conditions that could hinder FNMA's ability to carry out the public purposes for which it was established: to improve the distribution of investment capital available for home mortgage financing. A continuing source of concern is that FNMA is heavily burdened with a portfolio of low yielding, fixed rate mortgages, which were acquired prior to the interest rate crisis of 1979-1982. We are also concerned that legislative or administrative actions could inadvertently weaken FNMA's ability to carry out its public purpose or have other consequences inconsistent with the intent of Congress to improve the flow of mortgage finance to homebuyers.

We therefore ask GAO to set forth those factors which, in its opinion, will most significantly affect FNMA's ability to maintain the financial strength appropriate to the achievement of its public objectives. The report should address the following questions:

1. Size and structure of the mortgage market. What is the range of expert opinion on (1) the projected volume of mortgage lending for the remainder of this decade and (2) the portion of that demand that the secondary mortgage market must be prepared to meet? When and to what degree can private participants in the secondary mortgage market be expected to meet that demand? What market conditions could do most to increase or decrease the ability of private firms to respond? How would housing be affected if expansion of the secondary market does not match the demand? How will deregulation of deposit rates affect the market for long-term, fixed rate mortgages? Who are most likely to invest in these loans at different points in the rate cycle?

2. Countercyclical mortgage lending. Since 1968, when FNMA was transferred to private ownership, how has the corporation met its responsibility to provide countercyclical support for housing finance? How have FNMA's activities affected the ability of different groups of primary lenders to offer home mortgage lending during periods of tight credit? How has FNMA's countercyclical activity compared with that of other major sources of mortgage credit? What elements of FNMA's authority or corporate structure have contributed to FNMA's ability to provide countercyclical support to mortgage credit?

3. Burden of FNMA portfolio. How would FNMA's financial strength be affected by its portfolio of low yielding mortgages under alternative interest rate futures? Of the strategies FNMA has taken to offset the losses from its portfolio of low yielding mortgages, which have been successful, which have not? Which new products or services have contributed significantly to FNMA's financial strength during the past four years? What benefits have those products or services provided to borrowers? How do FNMA's strategies compare with those of other large portfolio lenders, such as savings and loan associations?

4. Market responsiveness. What financial obligations are created by FNMA's status as a privately owned corporation? How has the HUD approval process restricted FNMA's ability to adjust to rapid changes in interest rates, the mortgage lending industry and the capital markets? How do HUD regulatory procedures compare with those of other agencies (such as the Comptroller of the Currency, the Federal Reserve Board, and the Federal Home Loan Bank Board) that regulate financial institutions? What market innovations or other contributions has FNMA provided that were of direct benefit to the U.S. mortgage market, housingindustry or homebuyers? What changes in Federal oversight could increase FNMA's ability to innovate and respond to market signals while maintaining accountability for its public purpose?

5. Federal benefits. What is the value of benefits that FNMA receives directly or indirectly from the Federal Government? Please be specific about the valuation methodology used. How do those benefits relate to FNMA's ability to carry out its public purpose? How do those benefits compare to the costs to the Federal Government and to the economy that could result from a drastic weakening of FNMA's financial condition? How do those benefits compare -- in kind and in value -- with the direct and indirect benefits the Federal Government provides to other financial institutions, including government-sponsored corporations and federally chartered banks and thrifts? To what degree and in what ways do these benefits contribute to FNMA's financial soundness and capacity to carry out its public purpose?

6. Managerial capacity. What staff capabilities -- both in top management and elsewhere in the organization -- are vital to the financial soundness and operational competence of FNMA in a rapidly changing market environment? Against what types of organizations must FNMA compete to attract and retain that talent? How does the total compensation package (salary, bonuses, stock options, etc.) offered by FNMA to personnel in these critical areas compare with those of private financial institutions of comparable size ard complexity? with other privately owned, government-sponsored corporations (eg. Freddie Mac, Sallie Mae and COMSAT)?

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June 29, 1984
Page 4
Hon. Charles Bowsher

Since this analysis relates to other work of GAO and will provide information important to work of the next session of Congress, we ask that your report be submitted to us by January 1, 1985.

Sincerely,

Henry B. Gonzalez, M.C.

Donald W. Riegle, Jr., U.S.S.

Stewart McKinney, M.C.

GAO METHODOLOGY:

FNMA's Estimated Savings From the State and Local Income Tax Exemption During Profitable Years
(In millions of dollars)

	1975	1976	1977	1978	1979	1980	1981	1982	1983
1. Federal income taxes[a]	$110.2	$117.1	$152.5	$191.1	$137.8	$12.2	($169.5)	($123.4)	$63.2
2. All corporations' state/local income taxes as a percentage of federal income taxes[b]	16-36%	16-36%	16-36%	16-36%	16-36%	16-36%	--	--	16-36%
3. FNMA's estimated state and local tax without its exemption[c]	$17.6 to $39.7	$18.7 to $42.2	$24.4 to $54.9	$30.6 to $68.8	$22.0 to $49.6	$2.0 to $4.4	--	--	$10.1 to $22.8
4. FNMA's estimated federal tax rate[d]	48%	48.9%	48%	47.7%	47.8%	46.2%	--	--	45.6%
5. FNMA's savings resulting from its state and local tax exemption[e]	$9.2 to $20.6	$9.6 to $21.6	$12.7 to $28.5	$15.9 to $35.8	$11.5 to $25.9	$1.1 to $2.4	--	--	$5.5 to $12.4

[a]From FNMA financial statements, 1975-1983.

[b]The relationship of state/local income taxes to federal income taxes ranged from 16.3 percent in 1975 to 35.5 percent in 1983 and averaged 21.2 percent for the 9-year period. We used the 16 to 36-percent range in each of the yearly calculations. Source: U.S. Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, 1982-83 Edition.

[c]Calculated by multiplying item 1 by item 2.

[d]Estimated from FNMA financial statements, 1975-1983.

[e]Calculated by multiplying item 3 by 1 less than the federal tax rate (item 4).

APPENDIX III

FNMA's Estimated Savings From the State and Local Income Tax Exemption Expressed as a Percentage of FNMA's Income Before Taxes (In millions of dollars)

	FNMA Income before Taxes[a] (1)	FNMA's estimated savings from its state and local tax exemption (2)	Percentage (col. (2)/col. (1))
1983	$ 138.7	$ 5.5 to $12.4	4.0 to 8.9
1982	--	--	--
1981	--	--	--
1980	26.4	1.1 to 2.4	4.2 to 9.1
1979	299.6	11.5 to 25.7	3.8 to 8.6
1978	400.1	15.9 to 35.8	4.0 to 8.9
1977	317.6	12.7 to 28.5	4.0 to 9.0
1976	243.9	9.6 to 21.6	3.9 to 8.9
1975	225.2	9.2 to 20.6	4.1 to 9.2

[a] From FNMA financial statements, 1975 - 1983.

3900 Wisconsin Avenue, NW
Washington, DC 20016
202 537 6770

David O. Maxwell
Chairman of the Board and
Chief Executive Officer

April 5, 1985

Mr. J. Dexter Peach
Director
Resources, Community, and
Economic Development Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Peach:

Fannie Mae welcomes this effort by the General Accounting Office to evaluate for Congress our role in the swiftly changing American mortgage finance system.

Within the restricted time allotted for the study, GAO has done a most creditable job. The complexity of the changing secondary mortgage market and the new Fannie Mae, the novel challenges facing Fannie Mae in an era of high interest rates, the vast amount of data to assimilate -- all made for a demanding and difficult task. Moreover, the opinions of industry scholars and other experts differ greatly on what it all means, as is evident from the two seminars sponsored by GAO in its effort to research Fannie Mae and the industry.

We compliment the GAO staff on its success in identifying the complicated issues our corporation faces. They have made a fair and objective effort to put our role in the secondary mortgage market in context.

We are gratified that the GAO report recognizes that our corporation "is one of the major forces in the secondary market"; that it is "an integral part of the interdependent system for financing housing in the United States today"; has served as "an industry innovator and a standard setter"; and "has responded to new market demands."

GAO has also correctly characterized Fannie Mae's underlying business difficulties, which stem from a large block of low yielding, fully assumable mortgage loans purchased prior to 1981. When Fannie Mae completed its transition to private status in 1970, the company carried about $13 billion of these loans on its books. By 1981, Fannie Mae owned about $57 billion worth of long-term loans yielding about 9.24 percent, far less than the cost of debt it had to refinance. Management's strategies have whittled this portfolio down by $11 billion, but the remaining $46 billion still constitute a heavy burden on the company's financial statements.

We are further pleased that GAO, after considerable study, suggests no different strategy for the corporation to pursue from the one our new management adopted when we took charge in 1981. We believe that an informed analyst will agree that this strategy has been most appropriate given the nature of our inherited financial problems.

GAO states that Fannie Mae's aggressive strategy -- adding more fee income through new products and services, and reducing the maturity mismatch between assets and debt -- "may have reduced the likelihood of federal intervention being needed" in the event of a financial crisis. This strengthening of the company's ability to withstand an extended period of high interest rates is enormously significant. As the GAO report discusses, the various methods the government could employ to prop up Fannie Mae in a severe exigency range in cost from zero to billions. Therefore, our common aim must be to reduce the probability of that event. We certainly have done so, as the GAO report recognizes.

Fannie Mae has come far from the situation in 1981, when the corporation was losing $1 million every working day. At that time, as the report points out, Fannie Mae could not have afforded to withdraw from the market. The company desperately needed spread and fee income to help offset the drag caused by its underwater assets. Nor could the company sell these assets at a time when market interest rates were nearly double the average portfolio yield -- not without incurring massive losses and precipitating the very financial crisis it was seeking to avoid.

Like other portfolio investors in the housing finance industry -- principally the thrifts -- Fannie Mae needs time to restructure its balance sheet. The historically high interest rates of the 1980s have created an inhospitable environment in which to pursue restructuring strategies.

It is important here to stress the GAO report's observation that thrift institutions were given broad new non-housing powers to restructure -- while Fannie Mae was not.

Besides looking at Fannie Mae's business strategies in relationship to the Federal government's potential risk, GAO also focuses on the role Fannie Mae plays in the marketplace. The essence of that role is embodied in the explicit compact Congress made with Fannie Mae's shareholders in 1968 when Fannie Mae was rechartered as a private corporation.

Fannie Mae's shareholders, through this compact, agreed to restrict the corporation's business to serving America's low-, moderate-, and middle-income home buyers exclusively through the secondary mortgage market. That is our only business. In return, Congress granted Fannie Mae the benefits of its Federal ties, which provide the corporation access to the capital markets as an "agency" borrower. GAO acknowledges the connection between the company's limited business purpose and the financial support it receives.

In examining the benefits Fannie Mae provides the housing and home finance system through its compact with the Federal government, GAO concentrates on two of many roles the corporation has played in fulfilling its side of the compact: 1) its countercyclical role in providing a reliable supply of mortgage funds in both good and bad economic times; and 2) its services to low- and moderate-income home buyers. We believe these subjects deserve amplification.

As a result of financial deregulation, the focus of Fannie Mae's countercyclicality has shifted from augmenting the availability of funds to reducing the relative cost of those funds. During future "credit crunch" periods, deregulated thrifts will have to rely almost exclusively on uninsured high cost deposits to fund mortgage demand. Fannie Mae, on the other hand, can complement the thrifts by accessing "wholesale" markets much more inexpensively, and across a much wider range of maturities and investors.

Fannie Mae's capital market orientation provides a tangible and valuable benefit to the mortgage market. Indeed, as recently as late 1981 and 1982, when housing starts slumped dramatically and thrifts' deposits remained slack, Fannie Mae mitigated the damage by buying one out of every seven mortgages originated. (Early 1981 was atypical because previous management halted much of Fannie Mae's activity in response to the company's worsening financial condition; current management reversed that course in the second half of the year.) Fannie Mae's active role in late 1981 and 1982 reinforces our contention that the housing market will continue to benefit substantially from Fannie Mae's countercyclical mortgage purchases for the foreseeable future -- a point not stressed sufficiently in the report.

With respect to low- and moderate-income housing, the GAO correctly points out that the Government National Mortgage Association (GNMA), which is backed by an explicit government guarantee, has taken over the FHA/VA market through its competitive pooling of these mortgages for the successful GNMA mortgage-backed securities program.

While not competitive against GNMA within the government-insured and guaranteed portion of the market, Fannie Mae's conventional loan purchases evidence that the corporation remains committed to supporting low-, moderate-, and middle-income home buyers. In the first place, the maximum mortgage amount we can buy is now $115,300; this statutory limit excludes us from about 25 percent of the dollar volume of the market.

The dollar amount of our average mortgage purchase is also notably less than the national average. Adjusting for our purchases of two- to- four-unit mortgages, our estimated average single-family mortgage purchase in 1983 was $53,000 -- about 15 percent below the national mean. Fannie Mae's single-family purchase average has remained about 15 to 20 percent below the national figure over the past decade. Further, since the average loan-to-value ratio on our mortgage purchases is higher than the national average, this combination of smaller down payments and smaller mortgages should on average reflect support for buyers of lower-priced homes.

Equally important, Fannie Mae continues to pioneer new services for lower-income families. Indeed, not long before GAO began this study, Fannie Mae welded together diverse activities to enhance the credit ratings of state and local governments issuing multifamily housing bonds. The company continues to test and develop services to lower the cost of home financing for families in need of assistance.

But to focus the analysis of Fannie Mae's benefits almost entirely on these two roles is to ignore market evolution. It is like assessing IBM's role in today's information services market by discussing its punch card business. With the dramatic primary market changes that GAO ably describes in Chapter Two of this report, that market now looks to Fannie Mae to do far more than play a counter-cyclical role and support low- and moderate-income housing.

We certainly are pleased that GAO acknowledges that Fannie Mae has responded to new market demands and that the report discusses briefly some of the other benefits Fannie Mae provides. That responsiveness is one of the major reasons Congress harnessed private capital and management in recreating Fannie Mae in 1968. The mandate in the company's charter to provide supplemental assistance to the market envisions, indeed requires, just this kind of flexibility.

In the past few years, for example, the market has looked to Fannie Mae to: (a) help establish the market for soundly structured adjustable-rate mortgages and assist the housing recovery; (b) purchase non-standard mortgage products to help both home buyers and lenders deal with the affordability problem faced by millions of Americans; (c) serve as a means of tapping the capital markets (both domestic and international), thereby attracting a broadening base of investors to housing; and (d) promote pricing efficiencies by serving as a market-maker for various loan types, including, by way of recent example, co-op and second mortgages.

Fannie Mae's role in housing will evolve still further as new technologies become increasingly more important to the mortgage market. The corporation is investing substantial resources in technology-based services to be able to offer new and different benefits to the housing and home finance markets in the years ahead.

The only troubling aspect of the GAO report is its recommendation to Congress: 1) to increase regulatory oversight of Fannie Mae; and 2) to reinstitute GAO's audit authority over the corporation -- something Congress decided would be inappropriate for Fannie Mae as a private corporation in 1968 and eliminated in 1974.

We believe both recommendations are contrary to what is needed now if Fannie Mae is to function effectively as a privately managed company in a rapidly changing environment. Above all, Fannie Mae must have the ability to respond flexibly and quickly to the evolving demands of the marketplace.

The need for this adaptability has been recognized consistently in legislation enacted since Fannie Mae's rechartering in 1968 -- including the Secondary Mortgage Market Enhancement Act of 1984. GAO's recommendations could be construed to move Fannie Mae's regulation backward to a by-gone era, not to the world as it is and certainly not to the world as it will be in the years ahead.

The recommendations also run counter to expert thought on effective regulation. That thinking holds that government regulation, if too intrusive on a business's operational decisions, is likely to hurt a company's performance rather than enhance it.

We certainly acknowledge the need for oversight by the Department of Housing and Urban Development. But contrary to the GAO report's assumptions, we believe HUD has performed this function adequately over the last few years. Indeed, the interaction between HUD and the company has been thorough and continuous since 1981.

By establishing and monitoring Fannie Mae's debt-to-capital ratio, HUD regulates a key aspect of the corporation's financial and risk structure. This tool is similar to that wielded by regulators of other financial companies.

HUD's regulation of Fannie Mae should be performance-oriented, reviewing Fannie Mae's public policy achievements within the constraints imposed by the market and by current business conditions. The corporation should be allowed freedom to meet its objectives as its management chooses, and be reviewed regularly on that basis. Management has substantial incentives to do its job as well as possible, because it enjoys the rewards of success and suffers the penalties of failure.

As a private corporation whose stock is traded actively on the New York Stock Exchange, Fannie Mae's actions are, of course, also subject to scrutiny in the marketplace. Numerous investor analysts closely watch and report on the abundant financial data that Fannie Mae discloses quarterly. Fannie Mae's past and current financial problems, its strategy, and its record are no secret to anyone.

We believe that the recommendation that Congress should provide GAO audit authority over Fannie Mae is inconsistent with Fannie Mae's nature as a private, shareholder-owned corporation that paid the government $216 million for its ownership interest in 1970. Congress not only recognized this principle in the House Report on the 1968 act that rechartered Fannie Mae, but it also assigned the authority to HUD in 1968 and then removed GAO's audit authority in 1974. Like other private companies, Fannie Mae is audited by independent certified accountants who issue a public statement about our financial accounts each year. Fannie Mae's disclosures to shareholders and all others meet or go beyond the standards of SEC regulations, even though it is not required to do so.

In closing, I would like again to commend your staff for their professional work on this report. While Fannie Mae cannot concur with all of GAO's observations, we think you have performed a valuable service by shedding much informative light on our efforts to restructure and redirect Fannie Mae in the middle of a complex and fast-changing business environment.

Sincerely,

David Maxwell

DOM/rw

(387504)